LAST CHANCE TAX PLANNING: THE GOLDEN AGE OF ESTATE PLANNING WON'T LAST FOREVER

If You're Not Doing Estate Planning Now, What Are You Waiting For?

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If You're Not Doing Estate Planning Now, What Are You Waiting For?

Marvin E. Blum, J.D./C.P.A.
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In 2021, Congress shined a spotlight on many of the best tools in our toolbox that we use to avoid estate tax. Previously, many of these techniques were flying under the radar. Now that the general public is aware, there is a growing outcry to shut down these benefits. This is a wake-up call that, sooner or later, the tax landscape will likely drastically change. Now is the time to engage in "Golden Age" tax planning. We'll discuss key provisions of the various tax proposals still on the table, the Biden Administration's latest tax proposals, and what kinds of planning clients should be putting in place before it's too late.

The "Golden Age" of Estate Planning

Conditions for estate planning have never been better:

- Doubled estate tax exemption
- Valuation discounts
- Low interest rates
- Wide array of "squeeze & freeze" planning tools
- Use of grantor trusts to supercharge estate tax planning
    - Grantor avoids recognizing income on sales between grantor and grantor trusts
    - Grantor's personal payment of income tax on the trust's taxable income isn't a gift

Congress has not closed an estate planning loophole in over 30 years.

Key Legislative Developments

- December 2020: Consolidated Appropriations Act (longest bill ever passed by Congress) became law, at a cost of $2.3 trillion and no revenue in it to pay for it.

- March 2021: American Rescue Plan became law—$1.9 trillion of spending, with no revenue in it to pay for it.

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- November 2021: Bipartisan Infrastructure Bill became law, spending $1.2 trillion on infrastructure (roads and bridges, etc.) but does not include tax increases to raise the funds for the spending.

- November 2021: Build Back Better Act passed the House and is pending in the Senate. It is legislation intended to implement President Biden's social and educational reforms (provisions for education, labor, childcare, healthcare, taxes, immigration, and the environment) with an expected cost of between $1.75 trillion and $3.5 trillion.

  - There's speculation that the Build Back Better proposals may either be slimmed down in order to get approval from all 50 Democrat Senators or may be broken into pieces and the smaller pieces passed individually. However, to pass the Senate with 50 instead of 60 votes requires that the provisions be included in a budget reconciliation bill. Generally, only one reconciliation bill may proceed to the floor of the Senate each fiscal year, unless a majority of the Senate Budget Committee grants an exception. The Budget Committee has 11 Democrat and 11 Republican members, so the 11 Republicans could boycott any vote on additional reconciliation bills.

  - Clary Redd, a nationally recognized estate planning lawyer, said, "I'd bet my car—but wouldn't bet my house—that the BBB Act won't pass."

- March 2022: Biden Administration released its budget recommendations for fiscal year 2023. At the same time, the Treasury Department released their "Greenbook," a document detailing proposed tax increases aimed at generating revenue to cover the budget.

What's the Latest?

Not in Build Back Better Act

Were in Original Proposals but are not in Revised Build Back Better Act

- Early sunset of lifetime gift and estate tax exemption (accelerated from December 31, 2025).
- Limitation of valuation discounts when transferring entities holding "non-business assets" (passive assets not used in the active conduct of a trade or business).
- Grantor Trust assets includable in grantor's estate.
- Sales to Grantor Trusts recognized for income tax purposes and therefore subject to tax on the gain.
- Distributions from a grantor trust subject to gift tax if made to someone other than grantor or grantor's spouse.
- Grantor trust status ending treated as a gift of the entire trust on that date.
- Increase to income tax rates and change to thresholds for brackets.
- Increase to highest long term capital gains tax rate.
- Increase top corporate tax rate from 21% to 26.5%.
- Cap on maximum allowable Section 199A 20% pass-through deduction.
- Change to carried interest rules.
- Prohibit investment of IRA assets in entities in which owner has substantial interest.
- Prohibit IRA from holding any security that is subject to an issuer-imposed income or net worth test (Private Placement Investments).

Were Discussed but were not in Original Proposals Either

- No repeal of basis step-up at death.
- No forced recognition of gain at death.
- No limits on annual exclusion gifts.
- No limits on 1031 like-kind exchanges of real estate (limiting gain deferral).

What IS in the Build Back Better Act?

- New high-income surcharge based on modified adjusted gross income ("MAGI"). MAGI is adjusted gross income reduced by investment interest expense.

    - First Tier: 5% surcharge for individuals with MAGI over $10 million if married or single, $5 million if married filing separately, and $200,000 for trusts and estates. Surcharge applies to only the income over the threshold.

    - Second Tier: Additional 3% surcharge for individuals with MAGI over $25 million if married or single, $12.5 million if married filing separately, and $500,000 for trusts and estates. Surcharge applies to only the income over the threshold.

    - Note that charitable deductions (and other itemized expenses) do not reduce MAGI.

    - For trusts and estates, the surcharge is based on the AGI under Section 67(e) – not computed in the same manner as for an individual. AGI for a trust or estate can be offset by deductions for certain expenses to administer the trust/estate. Unlike an individual taxpayer, a trust or estate can offset its income by charitable deductions.

- Expansion of reach of the 3.8% Net Investment Income tax to include income from active trade or business if taxable income is over $500,000 for joint filing, $400,000 for single, and for all trusts and estates.

- New minimum tax of 15% on profits of corporations that report over $1 billion in profits.

- Crypto-currency:

    - Digital assets would be included in the constructive sale rules.

    - Crypto-currencies as well as foreign currencies and commodities now subject to wash-sale rules.

- Limit on exclusion rate for Qualified Small Business Stock ("QSBS") gains.

    - Section 1202 permits excluding a percentage of capital gain (up to $10 million of gain) from income when selling QSBS.

    - For taxpayers with AGI over $400,000 selling QSBS, the 75% and 100% exclusion rates are no longer available—only the 50% exclusion rate is available.

    - All trusts and estates are limited to the 50% exclusion rate.

    - The excluded gain is subject to Alternative Minimum Tax ("AMT").

- Limit on State and Local Tax ("SALT") deduction raised from $10,000 to $80,000 and extended through 2031.

- Section 461 limit on Excess Business Losses of noncorporate taxpayers becomes permanent.

- Corporate interest expense deduction—the interest expense deduction of certain domestic corporations—would be limited by a new Section 163(n).

- Surtax on corporate buybacks:

    - When a company buys back its own shares, the stock price generally increases, creating a form of dividend that isn't currently taxed.

    - The bill would impose a tax equal to 1% of the fair market value of any stock of a corporation that the corporation repurchases during the year. The provision would apply to any domestic corporation the stock of which is traded on an established securities market.

- Additional funding to IRS to beef up enforcement.

- Restricts Roth conversions if income is over $450,000 for joint filers, $400,000 for single, $425,000 for head of household. This provision would not be effective for 10 years.

- Caps IRA size if income is over $450,000 for joint filers, $400,000 for single, $425,000 for head of household. Cannot make additional contributions to Roth or traditional IRA if the combined value of IRAs and defined contribution plans exceeds $10 million, effective for 2029 tax year.

- Increases minimum distribution from large IRA if income is over $450,000 for joint filers, $400,000 for single, $425,000 for head of household. If combined value of IRAs, Roth IRAs, and defined contribution plans exceeds $10 million, new minimum distribution rules apply, effective for 2029 tax year.

    - Combined value over $10 million: Required minimum distribution of 50% of overage.

    - Combined value over $20 million: Required minimum distribution of lesser of (i) 100% of overage or (ii) total balance held in Roth IRA and Roth defined contribution plans.

- Additional reporting required for employer defined contribution plans on aggregate account balances of at least $2.5 million.

- No back-door Roth conversions. Can no longer convert any after-tax contributions (in a traditional IRA or an employer sponsored plan) to a Roth IRA or Roth 401(k).

Planning to Do Now

Take Advantage of Doubled Exemption ("Use It or Lose It" Planning)

To lock in the benefit of the doubled exemption before the December 31, 2025 sunset date, a couple has to transfer $24,120,000 out of their estate.

- If a couple decides to only give $12,060,000 instead of $24,120,000, make the gift entirely from one spouse and don't gift-split. Compare the outcomes:
    - Gifts first eat into the old or "original" exemption before eating into the "extra" exemption. If each spouse gives a gift of half the $12,060,000, after sunset they will have each used all of their "original" exemption and none of the "extra" exemption, so their remaining exemption is zero.
    - Instead, if the husband gives the entire $12,060,000, the wife will still have her "original" $5,000,000 exemption (adjusted for inflation) after her "extra" exemption sunsets.

Create and/or Fund a Children's Trust Now

- Create an Intentionally Defective Grantor Trust ("IDGT" or "Grantor Trust") to benefit children or grandchildren. Assets held in the trust will be outside the taxable estate.
- Creating as a grantor trust allows you to personally pay the income tax on the trust income rather than the trust paying its own income tax (and depleting trust assets to do so).

Interest Rates Are Rising

- Possibly even more urgent than taking use of the doubled exemption before the December 31, 2025, sunset date is locking in currently low interest rates.
- Sell assets to a Grantor Trust in exchange for a promissory note. In the future, if wanted, some or all of the note could be forgiven as a gift.
- Make a low interest, long term loan to your children or a trust to enable them to invest in deals.
- AFR rates for May 2022 are 1.85% (short-term), 2.51% (mid-term), and 2.66% (long-term).

"Squeeze & Freeze" While You Still Can

Some are hesitant to engage in estate planning for fear of losing control of the assets, losing access to the assets, or losing the flexibility to change their mind. There are some "freeze" planning techniques which allow the client to retain all these things. (You CAN have your cake and eat it too.)

- The Squeeze:
    - First, the client transfers the assets to a Family Limited Partnership ("FLP") to "squeeze" down the value of assets by the FLP units qualifying for valuation discounts.

    - Valuation discounts for lack of marketability and lack of control are routinely applicable to limited partnership interests as they are less marketable than assets held outright or assets traded on an exchange, such as stock of public companies or bonds.

- Next, "freeze" the value and lock in the discount by transferring the FLP units to a trust that is outside of the estate through gifts and/or sales.

- Make a gift to the trust equal to the balance of your lifetime exemption and then sell the rest to the trust in exchange for a promissory note.

    - Grantor Trusts for the benefit of children: Gifts to Grantor Trusts and sales to Grantor Trusts.

    - Spousal Lifetime Access Trusts ("SLATs"): Gifts to SLATs and sales to SLATs.

    - 678 Trusts (also called Beneficiary Defective Trusts or "BDTs"): Sales to 678 Trusts.

    - Grantor Retained Annuity Trusts ("GRATs"): Gifts to a GRAT, especially for mega-sized estates where it is difficult to have enough equity in the trust (or through a guaranty) to support a sale.

- Note: In freeze sales, the trust buying the assets from you pays with a promissory note. We customarily structure it as a 9-year note to use the mid-term AFR. However, with rates so compressed, consider a 25-year note, locking in the currently low long-term AFR. Also consider restructuring old notes as 25-year notes now in order to lock in the currently low long-term AFR.

Utilize Spousal Lifetime Access Trusts

The most popular way for married couples to use each spouse's gift/estate tax exemption is for each spouse to create a SLAT (Spousal Lifetime Access Trust) for the benefit of the other because doing so preserves the resources for the spouses' benefit.

Each spouse's gift would use part or all of their lifetime exemption amount, depending on the amount of assets transferred. Assets held in the SLAT would not be included in either spouse's estate at death. Think of it as a "lifetime bypass trust" for the benefit of a spouse.

- This locks in the higher lifetime gift and estate tax exemption before it sunsets in half, yet the spouses continue to benefit from the assets removed from their estates.

- The two SLATs must be substantially different to avoid the Reciprocal Trust Doctrine.

- Example:

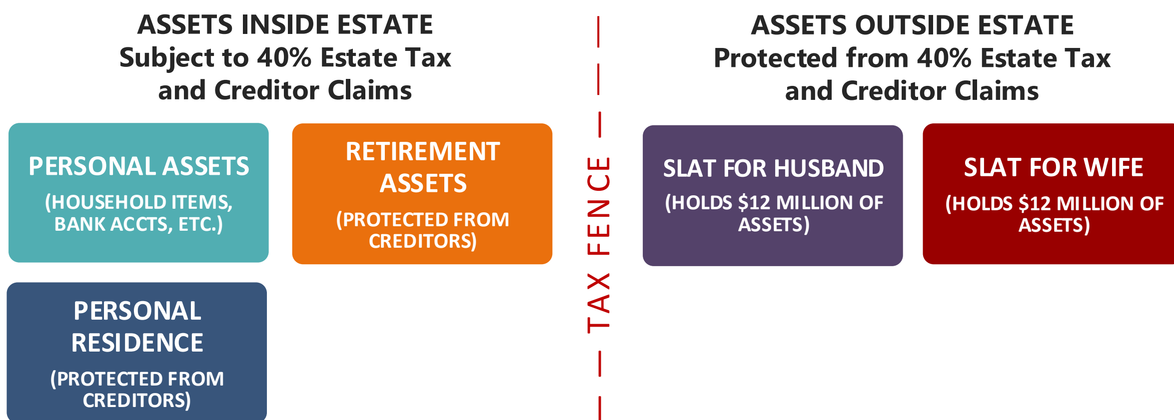
    - A husband and wife enter into a marital property agreement in which they agree to convert a portion of their community property into two separate property halves.

- The husband creates a trust for the benefit of the wife and funds it with $12,000,000 of his separate property. The wife has access to her SLAT for her needs during her lifetime. After her death, the remaining assets are split into separate trusts for the children.

- At a later date (the more time, the better), the wife creates a separate trust for the benefit of the husband and funds it with $12,000,000 of her separate property. The husband has access to his SLAT for his needs during his lifetime. After his death, the remaining assets are split into separate trusts for the children.

- While both the husband and wife are alive, the married couple retains access to the full $24,000,000. However, after the first death, the survivor only has access to $12,000,000. To replace the lost assets, each SLAT could buy an $12,000,000 life insurance policy on the life of the other spouse.

- If the husband dies first, at his death, the wife continues to benefit from her SLAT, plus her SLAT collects $12,000,000 on the husband's life, so her access to the full $24,000,000 isn't diminished when the husband dies. If the wife dies first, at her death, the husband continues to benefit from his SLAT, plus his SLAT collects $12,000,000 on the wife's life, so his access to the full $24,000,000 isn't diminished when the wife dies.



"Use It or Lose It" for a Single Person

If the single person can part with access, the easiest approach is a gift of $12,000,000 to a Grantor Trust for the benefit of children or others.

- If the donor needs access, consider having the donor borrow from the Grantor Trust on arm's length terms.

- The donor can retain a swap power to reacquire trust assets for assets of an equivalent value.

- An Independent Trustee could have ability to reimburse the donor for income taxes on trust income.

- Alternatively, to retain access, consider creating a Special Power of Appointment Trust ("SPAT"). The donor makes a gift to a trust for others but gives an independent party a special power of appointment ("SPOA") to make distributions to a class of donees that includes the donor. For example, the class of donees could be "the descendants of the donor's mother."

Utilize a 678 Trust

By utilizing a 678 Trust in the "freeze" stage, the client does not have to give up control of the assets or give up access to them.

The Consequences of Doing No Planning

- George and Sarah had a high net-worth, with a very illiquid estate of investment assets worth $75 million and $10 million of other assets (home, bank accounts, cars, personal assets).

- When they both unexpectedly die in an accident, the IRS sent their children a tax bill for over $24 million.

Investment Assets	$75,000,000
Other Assets	10,000,000
Total Assets	85,000,000
Less Estate Tax Exemption x 2	(24,120,000)
Taxable Estate	60,880,000
x 40% Estate Tax Rate	**$24,352,000**

Let's Rewind the Clock

- George and Sarah came to us several years ago to help prepare an estate plan.

- At the time, their investment assets were worth $60 million, and they had other assets worth $10 million (home, bank accounts, cars, personal assets).

Stage 1: A Family Limited Partnership to "Squeeze" Down the Value

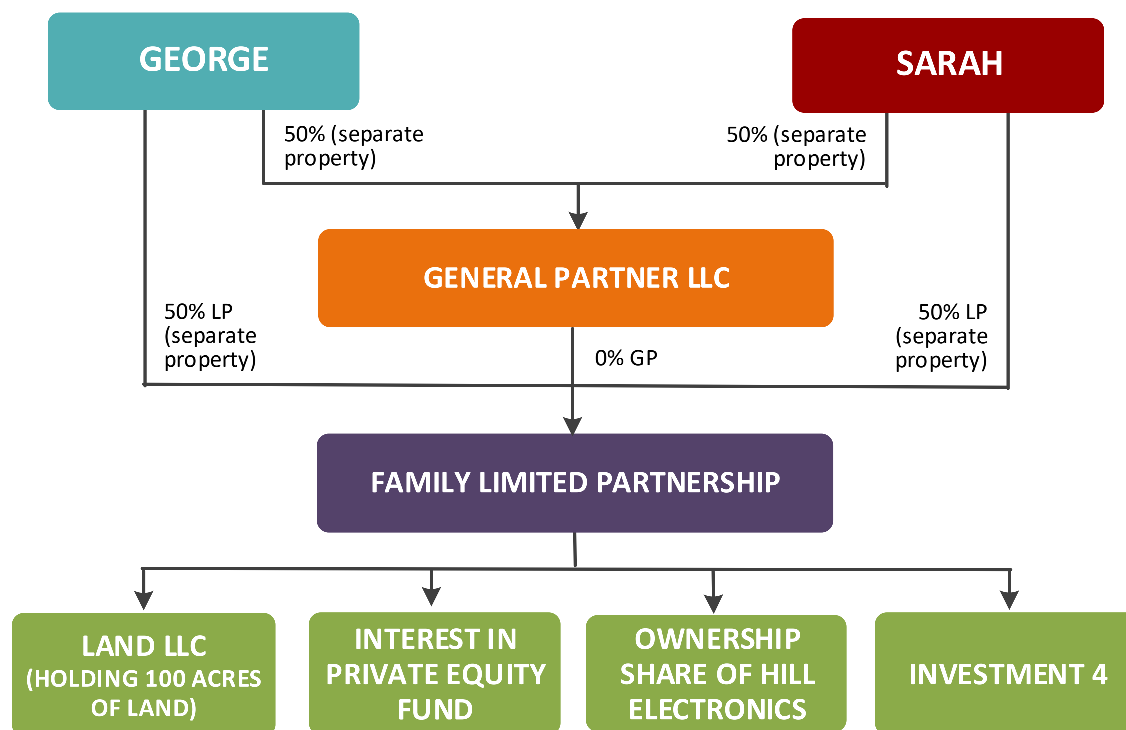
- Limited partnership interests are less marketable than assets held outright or assets traded on an exchange, such as stock of public companies or bonds.

- By virtue of the partnership form and standard restrictions in partnership agreements, a partnership interest is worth less than the underlying assets of the partnership.

- For minority, non-controlling interests, discounts for lack of marketability and lack of control are routinely recognized by the courts when the partnership is formed and maintained properly.

- For example, if a partnership is formed and funded with $1,000,000 in investment assets, the limited partnership interests associated with such assets might be valued at only $650,000 (representing a 35% discount for lack of marketability and lack of control).

- Create a structure that qualifies for the best possible valuation discount.
    - If it's a limited liability company or limited partnership, examine the agreement to ensure the entity will qualify for an optimum valuation discount.
    - If it's a C Corporation, transfer the stock to a limited partnership.
    - If it's an S Corporation, reorganize the structure to establish voting and non-voting shares. Then, perform tax planning with the non-voting shares, which could qualify for a valuation discount.
- George and Sarah put their investment assets into an FLP with a limited liability company ("LLC") as the general partner.
- George and Sarah are the initial limited partners of the FLP, and they each own 50% of the LLC.
- Notice that they put an LLC "wrapper" around the real estate they owned outright before putting the real estate into the FLP to provide an extra layer of protection around a risky asset.



<u>Stage 2: A Grantor Trust for the Children Begins the "Freeze"</u>

- "Freeze" planning involves gifting and/or selling the limited partnership interests to a trust which is outside of the estate for estate tax purposes, such as an Intentionally Defective Grantor Trust, a 678 Trust, or a Spousal Lifetime Access Trust.

- George and Sarah chose to create an Grantor Trust to benefit their children (the "Children's Trust") and fund it by making gifts to the trust using a portion of each spouse's lifetime gift tax exemption and GST tax exemption.

- With the trust structured as a grantor trust, the gift is "supercharged" because the grantors (George and Sarah) remain liable for the income tax attributable to the trust and pay the trust's income taxes out of their own funds. This allows the trust assets to grow without being depleted by income taxes.

- The Grantor Trust status can be "toggled" off later if the client no longer wishes to bear the trust's income tax liability.

- As beneficiaries of the Children's Trust, George and Sarah's children and their descendants would be entitled to distributions from the trust as necessary for their health, education, maintenance, and support ("HEMS") needs.

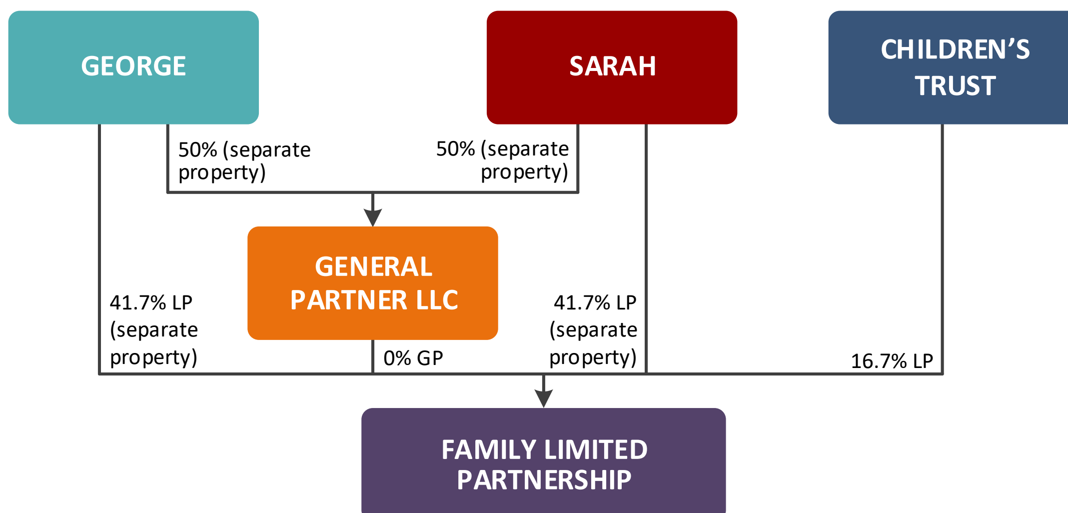
- At a child's death, he or she can be given an SPOA to direct the disposition of remaining trust assets.

- By George and Sarah allocating GST exemption to their gifts, the assets in the trust can pass free of estate taxes from generation to generation so long as law allows.

- The assets in the trust are also protected from the children's creditors and any divorcing spouses.

- George and Sarah gift 1/6 of their FLP interests to fund the Children's Trust, resulting in a gift of $3,250,000 from each of George and Sarah.

Underlying Assets	$60,000,000
Less Valuation Discounts of 35%	(21,000,000)
Value of FLP	39,000,000
Value of 1/6 of FLP Interests	**$6,500,000**



Disclosing the Gifts to the IRS

- George and Sarah file Gift Tax Returns (Forms 709) to disclose the gifts.

- The IRS has 3 years from the date a Gift Tax Return is filed to challenge the valuation. Once the 3-year statute of limitations has run, the IRS can no longer challenge the valuation. (*Note*: The statute of limitations is 6 years if the value omitted is over 25% of the reported gifts.)

- For the statute of limitations to begin, the disclosure must meet the requirements of Treasury Regulations Section 301.6501(c)-1(f)(2) for "adequate disclosure" which includes a copy of the trust agreement, the trust's EIN, the identities and relationship of the transferor and transferee, a description of the property, any consideration received in return, and a detailed description of the method and financial data used.

- In place of the detailed description of the method and data used, an appraisal report can be attached to the Gift Tax Return.

Stage 3: "Freeze" the Taxable Value of the Estate

- How do George and Sarah move the remaining 5/6 of FLP interests out of their estates?
    - They sell it to a 678 Trust.

- Why did they choose a 678 Trust?
    - George and Sarah can remain in control.
    - George and Sarah can be beneficiaries of the 678 Trust and can continue to have access to the assets for their needs.
    - The assets in the 678 Trust are not taxed in George and Sarah's estates.
    - George and Sarah can have an SPOA to direct where the assets pass upon their deaths.
    - The assets in the 678 Trust are protected from creditors.

678 Trust Basics

- A 678 Trust is established by a third party (such as the client's parents, sibling, or close friend) with a gift of $5,000.

- The client is the primary beneficiary of the 678 Trust and can receive distributions for health, education, maintenance, and support.

- With careful drafting, the client may also be named as trustee of the 678 Trust.

- The client-beneficiary is given a withdrawal right over the initial $5,000 contribution.

- The trust agreement provides that a Special Trustee has the power to terminate the trust in favor of the client-beneficiary, even after the client-beneficiary's withdrawal right over the $5,000 gift lapses.

- The 678 Trust technique works because of a "disconnect" between the income tax code and the estate tax code.

<u>Income Tax Code</u>

- IRC Section 678(a)(1) provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself.

    - When the client-beneficiary is given a withdrawal right over the $5,000 gift, the client-beneficiary becomes the owner of that portion of the trust for income tax purposes so long as the power remains outstanding.

    - Since the withdrawal right applies to all of the assets owned by the 678 Trust, the entire trust is treated as owned by the client-beneficiary for income tax purposes.

- Once the withdrawal right lapses, the client-beneficiary may continue to be the owner of the trust for income tax purposes under Section 678(a)(2).

    > *A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.*

    - This means that the client-beneficiary will be treated as the owner of the 678 Trust for income tax purposes if:
        (i) The client-beneficiary had a withdrawal right over trust assets that was partially released (or lapsed) and
        (ii) The client-beneficiary would be treated as the owner under Sections 671-677 if the client-beneficiary were the grantor of the trust.

    - If our client-beneficiary were the grantor, he would be treated as the owner under Section 676. Under Section 676, a grantor shall be treated as the owner of the trust for income tax purposes if the grantor or a non-adverse party has the power to terminate the trust in favor of the grantor.

    - Our Special Trustee, a non-adverse party, has the power to terminate the trust in favor of the client-beneficiary.

    - Therefore, our client-beneficiary remains the owner of the 678 Trust for income tax purposes, even after the withdrawal right lapses.

- The client-beneficiary will be responsible for reporting the income generated by the trust's assets on his income tax return. This allows the assets in the 678 Trust to grow without being diminished by income taxes.

- And, this sets the stage for the client-beneficiary to sell assets to the 678 Trust and not have to report any gain.

Estate Tax Code

- If the client-beneficiary is considered the owner of the 678 Trust for income tax purposes, does that mean the 678 Trust's assets are included in the client-beneficiary's estate for estate tax purposes?

    - Under IRC Sections 2041 (relating to estate tax) and 2514 (relating to gift tax), the exercise or release of a withdrawal power is deemed a transfer of the property by the person holding the power. As such, the property would be includable in the person's estate.

    - In our situation, our client-beneficiary allowed a withdrawal right to lapse. The question is: Is that "lapse" considered a "release"?

    - Sections 2041(b)(2) and 2514(e) provide that a lapse of power is indeed considered a release of such power unless the property which could have been withdrawn does not exceed the greater of $5,000 or 5% of the trust assets (the "5 and 5 exception").

    - For our trust, the withdrawal right is limited to $5,000, so it meets the 5 and 5 exception. For estate tax purposes, there was no release and no transfer of property. Therefore, the property is not includable in the client-beneficiary's estate if the trust is properly drafted.

- For the 678 Trust technique to work as intended, it is crucial that the client-beneficiary not be given a withdrawal right exercisable with regard to any other trust at any earlier point in the year of the gift.

    - The 5 and 5 exception is cumulative for each calendar year, so a withdrawal right over a gift earlier in the same year to the same beneficiary could eat into the 5 or 5 calculation.

    - For example, a withdrawal right over a $5,000 gift in January to an Irrevocable Life Insurance Trust ("ILIT") could use up the entire $5,000 amount, so a later gift that same year to a 678 Trust might not meet the 5 and 5 exception.

    - A remedy would be to include "hanging powers" language in the 678 Trust, so the withdrawal right would not lapse until a later year when there is sufficient space under such year's 5 and 5 exception.

Lapse Versus Release

- Sections 2041 and 2514 refer to a lapse of a withdrawal right, but Section 678(a)(2) refers to a partial release of a withdrawal right as the triggering event.

- Is a "lapse" of a withdrawal right considered a "partial release" under Section 678?

- Although the terminology is not exactly mirrored, the IRS has issued a private letter ruling interpreting a lapse under Sections 2041 and 2514 to be a partial release under Section 678. [PLR 200949012]

- In addition, the IRS has implied in prior private letter rulings that a lapse under Sections 2041 and 2514 would have the same effect of a partial release under Section 678. [PLRs 200747002, 200104005, 200147044, 200022035, 9809005, 8342088]

Recap: The "Disconnect"

For estate and gift tax purposes, when the client-beneficiary allows the withdrawal right to lapse, the client-beneficiary **is not viewed** as the grantor of the trust because of the 5 and 5 exception in the estate tax code, and so the trust assets are not includable in the client-beneficiary's estate.

For income tax purposes, when the client-beneficiary is given the withdrawal right and when the withdrawal right lapses, the client-beneficiary **is viewed** as the grantor of the trust, making the client-beneficiary the owner of the trust for income tax purposes. (Note: Although the withdrawal right is limited to $5,000, there is no 5 and 5 exception in the income tax code.)

Ideal Situations for a 678 Trust

A 678 Trust can be a useful tool for:

- Clients who are starting a business, are expanding a business, or are expecting to purchase an asset that has appreciation potential such as buying a new business opportunity, engaging in additional drilling operations, or making an investment that has substantial upside.

- Clients who have existing assets that have appreciation potential or that are valued at a discount, such as a portfolio of investments owned by an FLP.

- A closely held business owner who might be presented with an opportunity to sell the business at some point in the future.

678 Trust Structure

- Structure the 678 Trust to be a GST-exempt dynasty trust.

    - When the initial $5,000 gift is made to the 678 Trust, the third-party who makes the gift should file a Gift Tax Return allocating GST exemption to the gift.

    - After the initial $5,000 gift to the 678 Trust, no other assets are gifted to the trust. All future transfers to the trust are done by sales for fair market value.

    - Because all assets gifted to the trust are covered by the third-party donor's GST exemption, the trust is fully GST-exempt. Therefore, the 678 Trust's assets can pass to future generations free of transfer taxes, including estate tax at the death of the client-beneficiary or the children of the client-beneficiary.

- If our client-beneficiary is going to be trustee of the 678 Trust, does that make the trust assets reachable by the client-beneficiary's creditors?
  - Some states, such as Texas, protect the assets from creditors if the client-beneficiary's distributions are limited to an ascertainable standard.
  - Texas Trust Code Section 112.035(f)(1)(A) provides that a beneficiary is not treated as a settlor of a trust merely because the beneficiary has the power to "consume, invade, appropriate, or distribute property to or for the benefit of the beneficiary if the power is limited by an ascertainable standard, including health, education, support, or maintenance of the beneficiary."
  - Therefore, if the client-beneficiary serves as trustee, include a HEMS standard (for health, education, maintenance, and support needs), not only to prevent the trust from creating a general power of appointment which would cause the assets to be taxed in the client-beneficiary's estate, but also to protect the trust assets from creditors.
  - If extremely concerned about creditor reach or if not in Texas, an option is to use an independent trustee. If using an independent trustee, the distributions could be purely discretionary (not limited to an ascertainable standard).
- Does giving the client-beneficiary a withdrawal right expose the trust assets to the reach of creditors?
  - In some cases, giving a beneficiary a withdrawal right could make a "spendthrift trust" into a "self-settled spendthrift trust" with no protection against the beneficiary's creditors.
  - However, some states (such as Texas) include a 5 and 5 exception in their trust laws, protecting trust assets from creditors as long as the value of the property which could have been withdrawn does not exceed the greater of $5,000 or 5% of the trust assets. [See Texas Trust Code Section 112.035(e).]
  - To protect the 678 Trust assets from creditors, choose a state that provides such a 5 and 5 exception.

<u>Drafting Options</u>

- The 678 Trust can be drafted to, upon the clients' deaths, pour into an existing trust for the children's benefit or divide into separate trusts for the children.
- The 678 Trust can also be drafted to allow the client-beneficiary to exercise an SPOA.
  - *An inter vivos* SPOA can give the client-beneficiary the power to provide for trust property to pass to individuals or charitable organizations during the client's life.
  - A testamentary SPOA can give the client-beneficiary the power to control how the property will be distributed at death.
  - The SPOA must be drafted so that assets cannot be appointed to the client-beneficiary, the client-beneficiary's estate, or the creditors of either.

Moving Assets into a 678 Trust

- To move assets into the 678 Trust, the client-beneficiary sells assets to the 678 Trust in exchange for a promissory note. No gifts should be made to the 678 Trust beyond the initial $5,000 gift contributed by a third party. Any additional gifts could alter the income tax and estate tax characteristics of the 678 Trust.

- It is important that the sale be structured so that it will be respected by the IRS as a bona fide sale under IRC Section 2036.

- The sales price must be equal to the fair market value. If the IRS later determined the sales price was lower than the fair market value, the IRS would argue that the difference was a gift. Sale documents should include adjustment clauses to guard against such an unintentional gift.

- The interest rate on the promissory note should be at least equal to the applicable federal rate for the type and length of the loan.

- The 678 Trust needs to have sufficient substance to support the sale.

    - If the 678 Trust has not yet built up significant value, it can have other trusts or individuals (other than the client-beneficiary) guarantee the note owing to the client-beneficiary in exchange for a guarantee fee.

    - The assets pledged should equal at least 10% to 20% of the size of the promissory note (the higher, the better).

    - In order to avoid an unintentional gift to the 678 Trust by the guarantor, the 678 Trust needs to pay the guarantor an annual guarantee fee that would be comparable to the fee charged by an unrelated guarantor. The fee would continue to be paid each year until the promissory note is paid in full.

    - The rule of thumb we use to value the guarantee fee is 3% of the amount of assets pledged.

    - For example, if the assets pledged equal 20% of the size of the note, the guarantee fee would be 60 basis points of the size of the entire note (or, the size of the note multiplied by 0.006.)

George and Sarah's 678 Trust

- George's brother, Jim, created a 678 Trust to benefit George and Sarah and their descendants and funded it with a $5,000 gift.

- George and Sarah sold their remaining 5/6 FLP interest and all of their LLC interest (the general partner) to the 678 Trust and each received a 9-year promissory note for $16,250,000 in return, plus interest at the mid-term applicable federal rate.

Underlying Assets	$60,000,000
Less Valuation Discounts	(21,000,000)
Value of FLP	39,000,000
Value of 5/6 of FLP Interests	**$32,500,000**

- The Children's Trust had sufficient assets to pledge as the guarantor of 20% of the promissory note amounts.
- In return for the guarantees, the 678 Trust executed guarantee fee agreements agreeing to pay the Children's Trust annual fees equal to 3% of the amount guaranteed.
- The annual guarantee fees paid by the 678 Trust to the Children's Trust are $195,000.

Promissory Notes	$32,500,000
Guaranteed Portion	x 20%
	$6,500,000
Guarantee Fees	x 3%
	$195,000

<u>Disclosing the Sale to the IRS</u>

- The $5,000 gift-maker should file a Gift Tax Return to disclose the gift and to allocate $5,000 of their GST exemption to the gift.
- The client-beneficiary should file a Gift Tax Return to disclose the sale.
- Why would you want to disclose a transfer that's not a gift?
    - Disclosing the sale on a Gift Tax Return starts the 3-year statute of limitations during which the IRS can challenge the valuation.
- Doesn't disclosing the sale just bring the transfer to the IRS's attention? If the IRS doesn't know about the transfer, how can they challenge the valuation?
    - The transaction will have to be disclosed at some point, assuming the client's estate will be required to file an Estate Tax Return (Form 706). Without the statute of limitations running, the IRS could challenge the valuation at any time.
- How do you disclose a sale transaction on a Gift Tax Return?
    - Attach a statement to the Gift Tax Return electing to disclose a non-gift completed transfer pursuant to Treasury Regulations Section 301.6501(c)-1(f)(4).
    - Indicate why the transfer does not constitute a gift.

  - Include all the information required to adequately disclose a gift.

- The appraisal report already obtained for the earlier gifts can be used to value the assets sold.

- The appraisal value sought should be on the mid-range of the scale of reasonableness. If the appraisal is too aggressive and results in a value lower than that reasonably determined by the IRS, it is possible that the client will be treated as having made a gift to the trust equal to the difference between the appraised value and the IRS-determined value.

- Hiring a qualified appraiser and obtaining a top-quality appraisal report to attach to a Gift Tax Return is money well spent.

- George and Sarah file Gift Tax Returns disclosing the sale.

- If George and Sarah were to die after the investment assets have appreciated from $60 million to $75 million (but before the promissory notes were paid down), the estate tax would be $9,952,000.

Promissory Notes	$32,500,000
Other Assets	10,000,000
Total Assets	42,500,000
Less Remaining Exemptions	(17,260,000)
Taxable Estate	24,880,000
x 40% Federal Estate Tax Rate	**$9,952,000**

  - Estate tax with no planning: $25,056,000.
  - Estate tax with Squeeze & Freeze: $9,952,000.

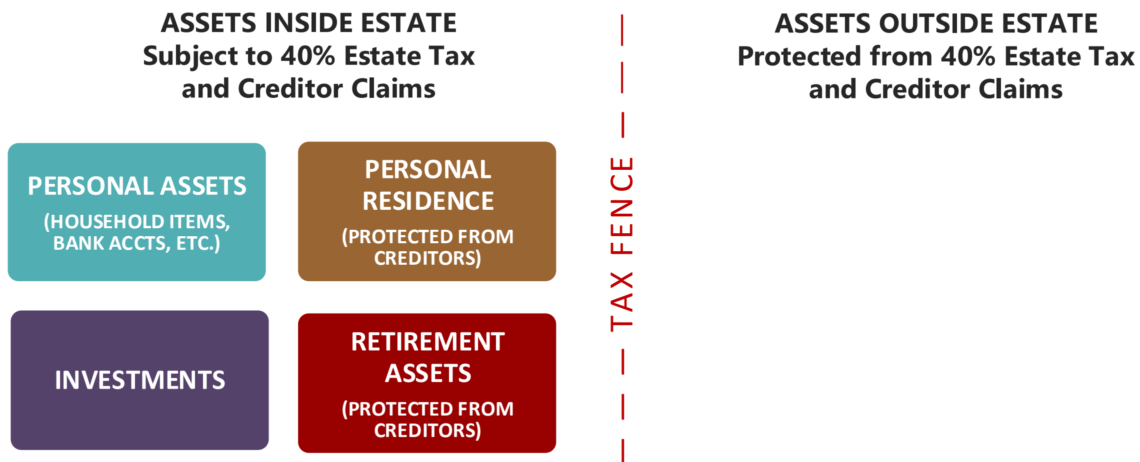
<u>Stage 4: "Burn" Down the Remaining Assets Subject to Estate Tax</u>

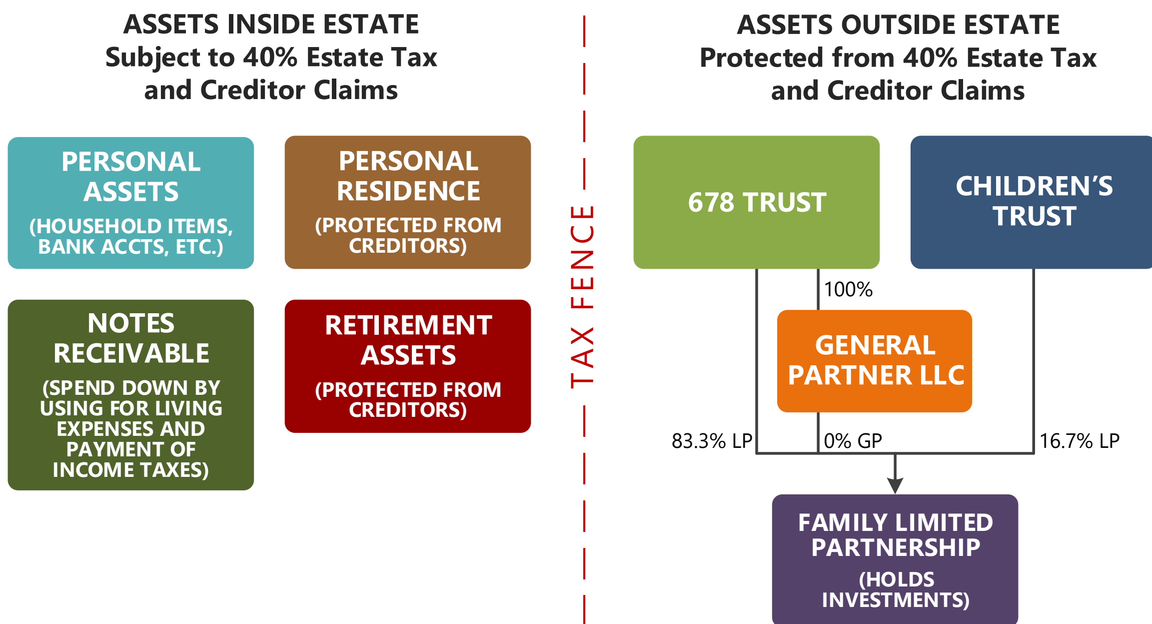
- George and Sarah use the assets that remain in their taxable estate for their living expenses and to pay the income taxes generated by the Children's Trust and the 678 Trust.

- As the note payments are "burned" down in order to provide George and Sarah with cash to pay living expenses and income taxes, the estate tax savings will be even greater.

- After the notes are paid off, the trustee of the 678 Trust will make distributions to George and Sarah under the HEMS standard to cover their living expenses and income taxes.

Results After Squeeze, Freeze, & Burn with a 678 Trust





Benefits Over Other Freeze Planning Techniques

- The client doesn't have to give up access to the assets or control of the assets.
    - George and Sarah could have sold their remaining 5/6 of the FLP interests to the Children's Trust. This would have effectively transferred future appreciation out of their taxable estate, but George and Sarah would have lost access to the funds generated by the investment assets once the promissory notes were paid in full.

- The client doesn't have to survive the transaction with the 678 Trust by any period of time in order to move assets out of the client's estate, such as with a GRAT.
- Unlike with the Children's Trust or a GRAT, the terms of the 678 Trust can be modified by the client by a testamentary SPOA, allowing the client to account for changes in circumstances or a change in the law.
- Unlike with a GRAT, the estate tax inclusion period ("ETIP") rules do not apply, so GST exemption can be allocated at the creation of the 678 Trust, and it only needs to be allocated to the $5,000 gift in order for the entire trust corpus to be GST exempt.
- Unlike a GRAT where the grantor cannot add new assets to it after inception, the client-beneficiary can make additional future sales to the same 678 Trust.
- Assets in the 678 Trust do not constitute marital property, protecting the assets if a beneficiary of the 678 Trust gets a divorce.

The Trade-Off: Squeeze & Freeze Versus Stepped-Up Basis

For years, we've urged clients to transfer assets out of the estate, typically to a grantor trust so the gift is super-charged because the grantor continues to pay the income tax generated by the assets.

The problem is that at the grantor's death, the assets in the trust won't receive a basis step-up. Do the math.

Determine if the expected estate tax savings exceeds the projected capital gain tax cost from loss of the step-up.

Have your cake and eat it too. Transfer assets to irrevocable grantor trusts to remove them from the estate. But, before the grantor's death, take action to move the assets from the grantor trust back into the estate so that the assets will receive a step-up at the grantor's death.

Swap Assets Back into Estate for Basis Step-Up

Grantor trusts commonly give the grantor a swap power, allowing the grantor to remove assets from the trust and swap them with assets of equal value. The grantor would exercise that power to remove the low-basis assets from the trust and replace them with cash or high-basis assets. The low-basis assets would be in the estate at death and receive the step-up.

- Example:
    - Norman bought a ranch 60 years ago for $500,000. He previously gifted the ranch to an irrevocable trust he created for the benefit of his daughter. The trust contained provisions allowing the grantor to swap assets to and from the trust (making it a grantor trust). The ranch has a current fair market value of $5 million.
    - At Norman's death, the ranch would not be included in Norman's estate and therefore would not receive a step-up in basis.

    - Recognizing that he has a short life expectancy and that the ranch has a low basis, Norman decides to exercise his swap power. Norman transfers high-basis assets and/or cash with a total value of $5 million into the trust and pulls the ranch out of the trust.

    - At Norman's death, the ranch is includable in his estate and receives a basis step-up to $5 million.

- What if the client doesn't have enough cash or high-basis assets to swap? Consider borrowing cash.

    - The borrowed cash could be swapped for the trust's low-basis assets, or the borrowed cash could be used to purchase high-basis assets to swap. Or, alternatively, the client can buy the assets from the trust and the trust will carry a note. The sale will not be subject to income tax because the grantor is purchasing assets from his own grantor trust.

- Example:

    - Norman can buy the low-basis assets from the grantor trust. Norman signs a promissory note owing to the trust. Norman should hire an appraiser to appraise the value of the assets in the trust and, ideally, to appraise the value of the promissory note. To bolster the value of the promissory note, the note should be secured by the assets being purchased or by other assets.

    - If it is likely that the assets will substantially appreciate inside Norman's estate prior to his death and it's a concern that it'll throw Norman over the exemption level, Norman should use an interest rate on the note that is higher than the AFR. The higher interest Norman pays can offset some of the growth in his estate.

- What if Norman bought the low-basis assets from the grantor trust for a promissory note but dies before he repays the note?

    - The unpaid balance of the note would be includible in Norman's estate for estate tax purposes.

    - When the note is later paid off by the estate, there is no clear answer on whether the gain portion of the note payments received by the trust after the grantor's death are subject to income tax.

    - So, this scenario works best if the note is repaid before the grantor dies.

Use Court Reformation to Move Assets into Estate for Basis Step-Up

Court reformation is especially useful (i) when the first spouse has died and left assets to a bypass trust and the surviving spouse has enough exemption available to cover the survivor's own assets plus the assets in the bypass trust, or (ii) when a trust doesn't allow for swapping assets.

Assume the value of the wife's outright assets together with the value of the assets in the bypass trust total less than the wife's estate tax exemption. We can remove the assets from the bypass trust and put them in

the wife's name, and the wife will still not owe any estate tax. The assets that were in the bypass trust would now get a step-up at the wife's death. How do we make this happen?

- Ask the court to grant the surviving spouse (the beneficiary of the bypass trust) a general power of appointment ("GPOA") over the appreciated assets, causing the assets to be included in the surviving spouse's estate.

- Or, alternatively, the court could order the trustee to distribute the assets outright to the wife due to changed circumstances.

Make Distribution to Move Assets into Estate for Basis Step-Up

How can we do this without going to court? Assume a surviving wife is the beneficiary of a bypass trust that owns low-basis assets, and her estate is below the exemption level. Is there a way to transfer an amount of low-basis assets to the wife to soak up her unused exemption so that the assets will get a step-up at her death?

- If the trustee of the bypass trust can justify a distribution to the wife for HEMS needs (or however the trust's applicable distribution standard reads), the distributed assets would go back into her estate and qualify for a step-up.

Upstream Planning: Gift Appreciated Assets to Parent with GPOA

If the client has appreciated assets, the client should look "upstream" to the client's parent for obtaining a stepped-up basis, especially if the parent is ailing.

> *At the risk of being tactless, the death of a parent, grandparent, or other older relation or friend is a sad enough event without also wasting the opportunity for a significant basis increase.*
>
> ~Howard Zaritsky, nationally known estate planning attorney

If the client has low-basis assets and the client's parent has unneeded exemption, the client could gift the assets a parent outright or, even better, to a trust for the parent and give the parent a GPOA over the assets.

- Caution: IRC Section 1014(e) denies the basis step-up if the assets come back to the child or the child's spouse within one year. This potential limitation may be avoided if the assets pass (i) to a trust for the benefit of the client and/or the client's spouse with a trustee other than the client or client's spouse or (ii) to the client's child or a trust for the child's benefit.

- Example:

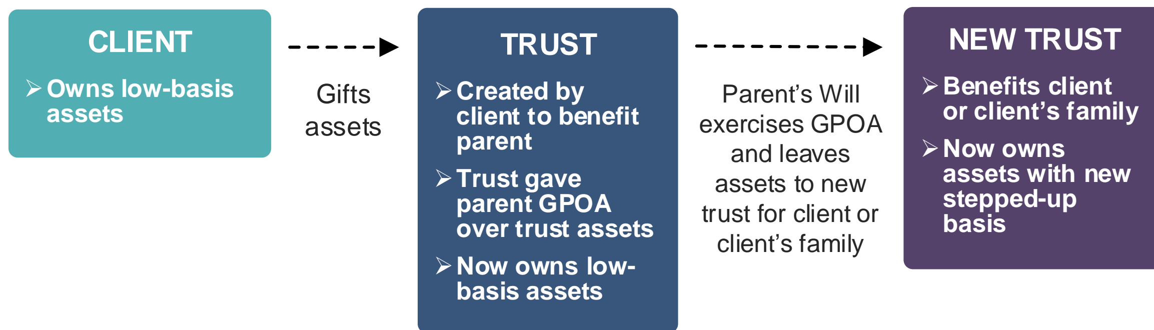
    - The client creates a trust benefitting the parent and gifts low-basis assets to the trust.

    - In drafting the trust, the client gives the parent a GPOA over the trust assets. The GPOA will cause the assets to be included in the parent's estate under IRC Section 2041(a)(2).

    - In the parent's will, they exercise the GPOA and leave the assets to a trust for the client.

- When the parent dies and the assets come back to a trust for the client, the assets will have a new stepped-up basis (under IRC Section 1014(b)(9)).

- Note that the outcome is the same if the trust is drafted so that if the GPOA is not exercised, the assets pass back to the donor child or to a trust benefitting the donor child. In this case, there would be no need for the parent to even exercise the GPOA.



Using Partnerships for Basis Bump Planning

"Mixing Bowl Planning" occurs when a partnership distributes property in a way that increases or decreases the basis of one partnership asset and triggers a corresponding decrease or increase in the basis of another partnership asset. Assume a family owns a high basis asset it plans to keep (such as a life insurance policy) and a low basis asset it wants to sell (such as a building). Through careful mixing bowl planning, the family can shift the high basis on the life insurance policy over to the building. The life insurance policy ends up with a low basis, but the family doesn't care since it plans to hold the policy until death and collect the proceeds free of income tax.

Mixing Bowl Planning Resulting in Basis Shifting

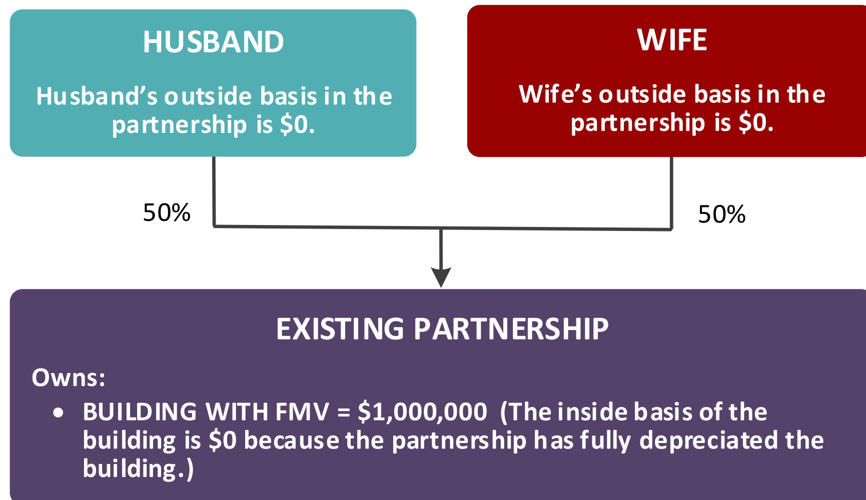
With basis shifting, the partnership makes a liquidating distribution of a low basis asset to a partner who has a high outside basis, thus increasing the asset's basis to the level of the former partner's old outside basis. The partnership must then make a corresponding downward basis adjustment to the assets remaining inside the partnership. So, the retained asset has effectively "shifted" its basis to the distributed asset. The liquidated partner can now sell the asset without incurring taxable gain.

- Example:
    - Husband and Wife have a partnership which owns a low-basis building. Husband and Wife each have a low outside basis in the partnership. Husband and Wife gift their interests to Daughter's Trust and Son's Trust. After the gifts, Husband and Wife are no longer partners in the partnership.
    - Sometime later, Husband and Wife contribute cash to the partnership, giving them a high basis partnership interest.
    - The partnership uses the cash to purchase life insurance and later distributes the building to Husband and Wife in a liquidating distribution, increasing the basis of the building to equal the outside basis of Husband and Wife. The partnership's basis in the life insurance is decreased by the amount of the increase in the building's basis.

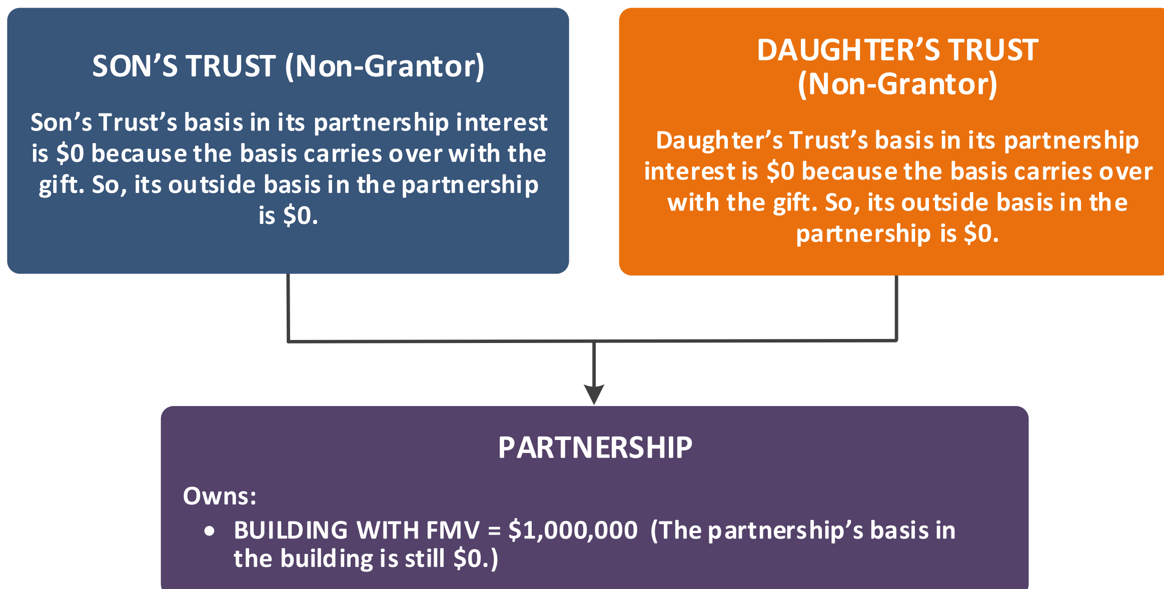
- Husband and Wife later sell the building and recognize little or no gain.
- When the life insurance policy matures upon the death of the insured, there is no gain or loss on the receipt of the life insurance proceeds (because under IRC Section 101, life insurance proceeds are not subject to income tax).

- Let's walk through this scenario:

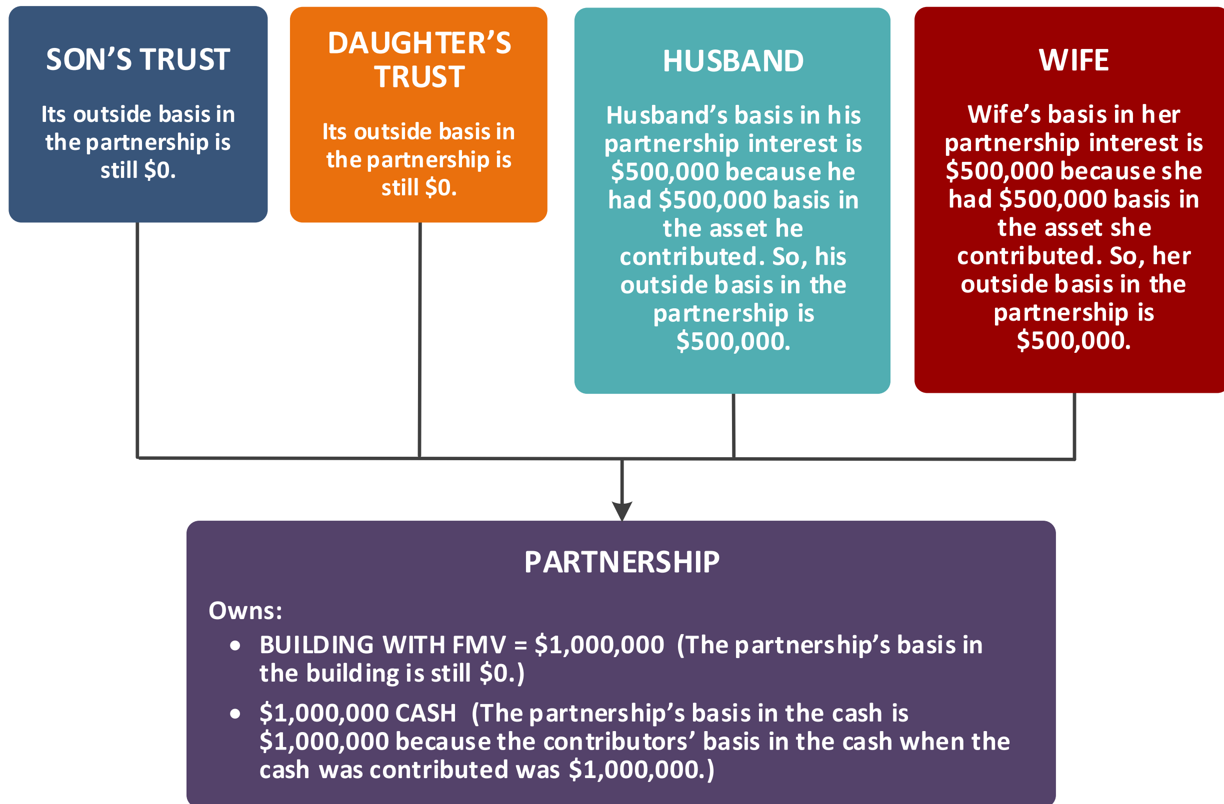
Step 1: Husband and Wife previously formed a partnership and contributed a low basis building to it. The building has an FMV of $1,000,000.



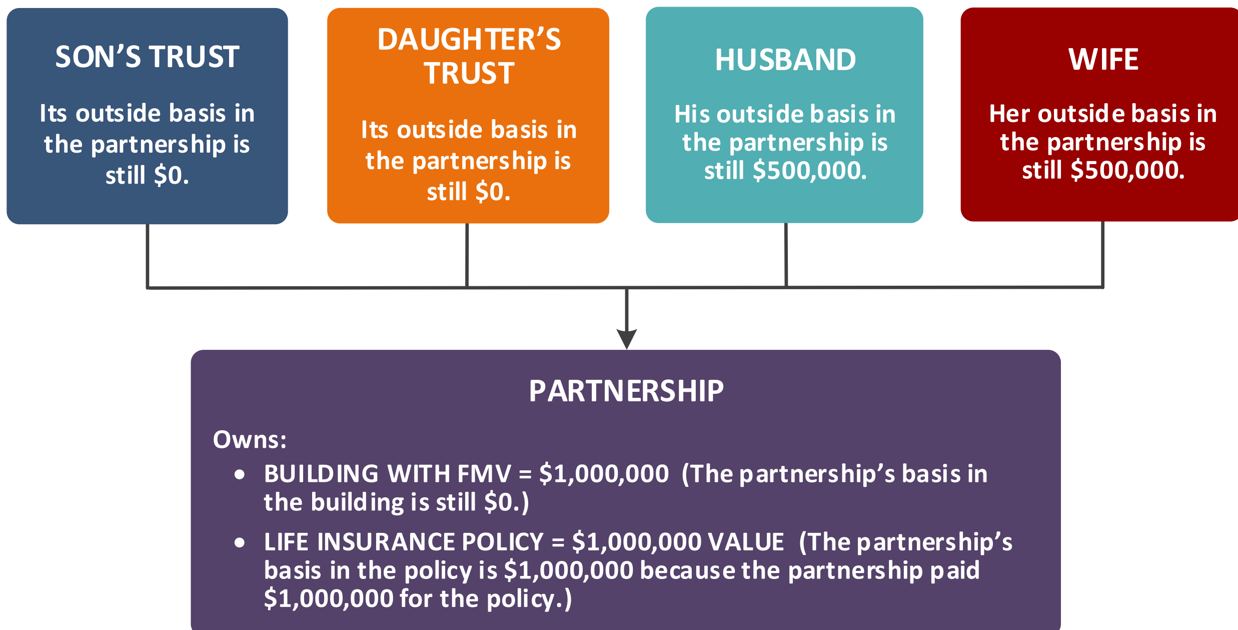
Step 2: Husband gifts his interest to Son's Trust, and Wife gifts her interest to Daughter's Trust. After the gifts, Husband and Wife are no longer partners in the partnership.



Step 3: Sometime later, Husband and Wife each contribute $500,000 cash to the partnership.



Step 4: The partnership uses the cash to purchase life insurance.



Step 5: The partnership liquidates Husband's and Wife's interests in the partnership by distributing the building to them.

Because Husband's outside basis was $500,000 and 50% of the building was distributed to him in liquidation of his interest, the basis in the 50% of the building is adjusted from $0 to $500,000. (IRC Section 732(b) requires this basis increase; no election is needed to effect this.)

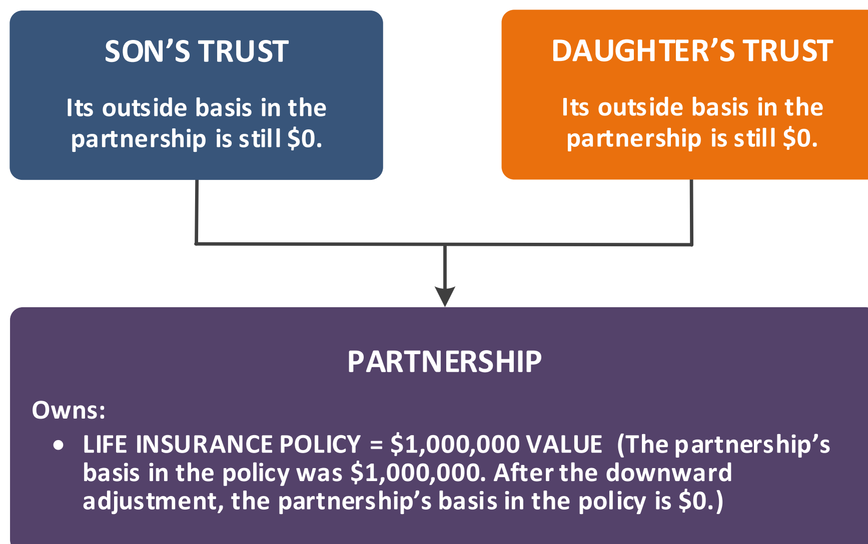
The same occurs for Wife's 50% of the building. The basis in her 50% of the building is adjusted from $0 to $500,000.

Husband and Wife can now sell the building for $1,000,000 and pay no tax on the sale.

Step 6: Because the partnership had a "substantial basis adjustment" as defined in IRC Section 734(d), the partnership now must make a compensating downward adjustment of $1,000,000 to its remaining assets.

The partnership's only remaining asset is the life insurance policy. The basis of the life insurance policy is adjusted downward by $1,000,000.

Note that this adjustment would not be required if the basis of the building had increased by less than $250,000 which would not have constituted a substantial basis reduction (unless the partnership had previously made a Section 754 election).



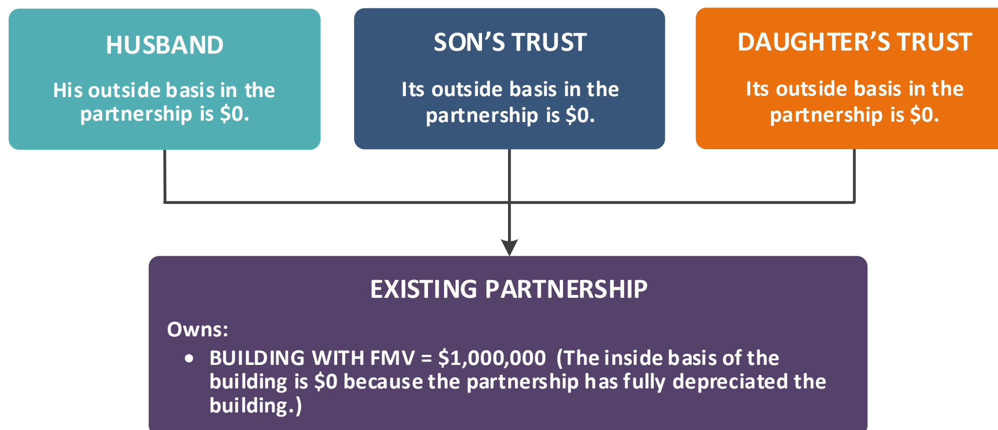
Step 7: When the life insurance policy matures upon the death of the insured, there is no gain or loss on the receipt of the life insurance proceeds even though the policy has no basis (because under IRC Section 101, life insurance proceeds are not subject to income tax).

Mixing Bowl Planning Using Basis Stripping

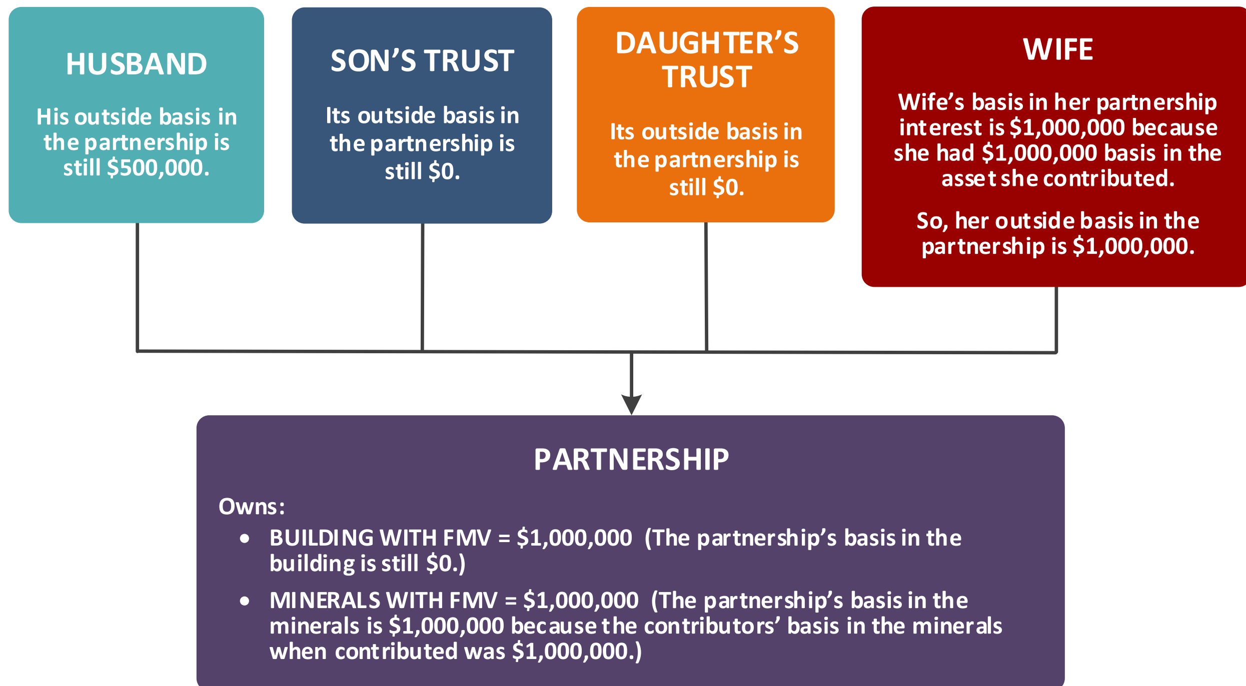
With basis stripping, the reverse occurs. The partnership distributes a high basis asset to a partner who has a low outside basis. The distributed asset takes the partner's low outside basis, and the "lost basis" is shifted over to assets remaining inside the partnership, i.e., the basis of the distributed asset is stripped off of the distributed asset and given to the retained assets. The partnership can now sell its retained assets and incur less taxable gain. Or, if the assets are depreciable, the partnership can begin taking depreciation deductions using the new basis.

- Example:
  - Wife inherits minerals that have a stepped-up basis and contributes them to the partnership, which is owned by Husband, Daughter's Trust, and Son's Trust.
  - Prior to the contribution, the partnership owned a low basis building and the partners (Husband, Daughter's Trust, and Son's Trust) each had a low outside basis.
  - After some time has passed, the trusts receive the minerals as part of a liquidating distribution, which decreases the cost basis of the minerals to the level of Daughter's Trust's and Son's Trust's outside basis.
  - The building's basis is increased by the amount that the basis of the minerals decreased.
  - The partnership may now begin depreciating the building based on the building's new higher basis. The percentage depletion of the minerals is not affected by the minerals' negative basis adjustment.
- Let's walk through this scenario:

Step 1: Husband, Son's Trust, and Daughter's Trust are partners in a partnership. The partnership owns a fully depreciated building with an FMV of $1,000,000.



Step 2: Wife inherits minerals worth $1,000,000 with a basis of $1,000,000 and contributes the minerals to the partnership.



Step 3: After some time, the partnership liquidates Son's Trust's interest and Daughter's Trust's interest by distributing the minerals to them.

Because Son's Trust's basis in its partnership interest is $0 and 50% of the minerals was distributed to it in liquidation of its interest, the basis in the 50% of the minerals is adjusted from $500,000 to $0.

The same occurs for Daughter's Trust's 50% of the minerals. The basis in the 50% of the minerals is adjusted from $500,000 to $0.

The percentage depletion of the minerals is not affected by the minerals' negative basis adjustment.

Note: Son and Daughter don't mind the basis decrease. First, most people never think of selling minerals. Second, they qualify for the same percentage depletion deduction whether the basis is $1,000,000 or $0. The percentage depletion uses the basis up pretty fast. Therefore, for many people, their basis in their minerals is irrelevant to them.

SON'S TRUST

- Owns 50% of the minerals.
- Its 50% is worth $500,000.
- Its basis in the 50% of the minerals is adjusted from $500,000 to $0 because the outside basis is $0.

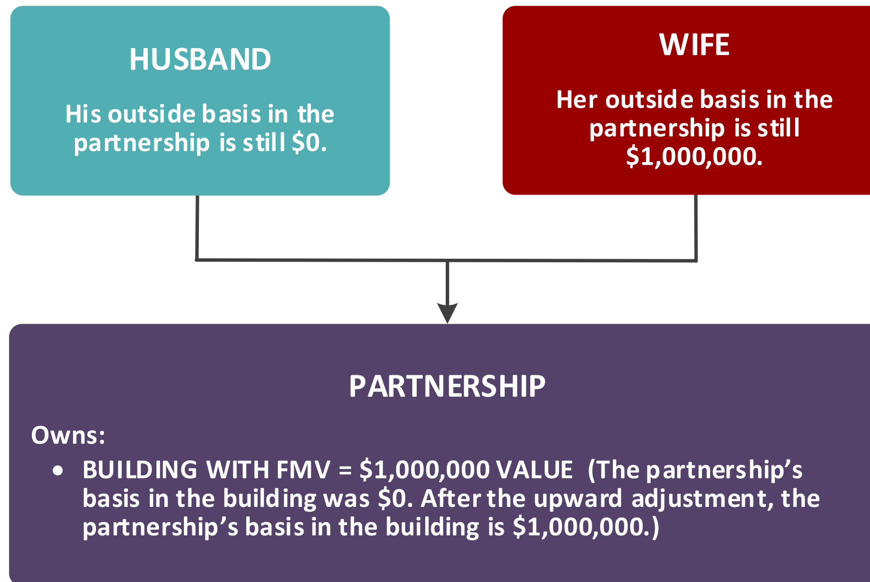
DAUGHTER'S TRUST

- Owns 50% of the minerals.
- Its 50% is worth $500,000.
- Its basis in the 50% of the minerals is adjusted from $500,000 to $0 because the outside basis is $0.

Step 4: If the partnership has an election under Section 754, the partnership now must make a compensating upward adjustment of $1,000,000 to its remaining assets.

The partnership's remaining asset is the building.

The basis of the building is adjusted upward by $1,000,000.



Step 5: The partnership may now begin depreciating the building based on the building's new higher basis or may sell the building for $1,000,000 and have no gain.

Caution: This is a high-level summary of partnership basis shifting and basis stripping designed to provide a broad overview of the planning opportunity. Before proceeding with this type of planning, be aware that all tax rules need to be considered, some of which are beyond the scope of this presentation.

Income Tax Planning

IRA Planning

- Consider converting your traditional IRAs to Roth IRAs.
    - If you expect income tax rates to rise, convert to Roth now and pay the tax at today's lower rate.
    - Remember that the amount converted will be taxed as ordinary income and, therefore, could push you into a higher income tax bracket.
- Consider withdrawing assets from a traditional IRA, paying the income tax, and gifting the net to a Grantor Trust or SLAT to remove the IRA from the estate. You are paying the income tax early but avoiding a 40% estate tax on the IRA at death.

- Consider leaving the IRA to charity, avoiding both estate tax and income tax on the IRA.
    - Note: If you do this, don't engage in either of the above two ideas, as you would be paying income tax unnecessarily on the portion of your IRA ultimately going to charity.

Charitable Remainder Unitrusts

Charitable Remainder Unitrusts ("CRUTs") are irrevocable trusts established for the benefit of designated income beneficiaries (often the settlor) and one or more charitable remainder beneficiaries. CRUTs can last for the settlor's lifetime or for a fixed term of up to twenty years.

In the year the assets are contributed to the CRUT, the settlor gets an income tax charitable deduction for the present value of the remainder interest that will go to charity.

The CRUT distributes a percentage of the trust assets to the income beneficiary/settlor at least annually. The amount distributed annually must be set at a fixed percentage of at least 5% of the trust assets but not more than 50%, and the remainder amount expected to go to charity must be at least 10% of the fair market value of the assets contributed to the CRUT.

When a CRUT sells an appreciated asset, the recognition of gain is deferred until the CRUT distributes it to the beneficiary. Distributions carry out income to the beneficiary on a WIFO (worst in, first out) basis. Keep a tally of income accumulated in the trust, and it is distributed in this order: ordinary income, then capital gain, then tax exempt income, and finally return of principal.

- Example 1 (typical):
    - The client has an appreciated real estate asset with a value of $1 million, and the client's basis in the real estate is $100,000. The client transfers the real estate to the CRUT.
    - The client has structured the CRUT so that the present value of the reminder interest is $100,000. He immediately gets a $100,000 income tax charitable deduction for the year he funds the CRUT.
    - The CRUT can sell the real estate for $1 million and reinvest the $1 million.
    - The capital gain is not recognized upfront. As distributions include capital gain, a portion of the gain is recognized.
- Example 2 (variation):
    - The client owns real estate with a value of $1 million, and the client's basis in the real estate is $100,000. The client transfers a 70% undivided interest in the property to the CRUT and keeps the remaining 30% undivided interest.
    - The client structures the CRUT so that the present value of the remainder interest is $270,000. The client gets a $270,000 income tax charitable deduction.
    - The real estate is sold to a third party for $1 million. The client receives $300,000 of the sales proceeds, and the CRUT receives $700,000 of the sales proceeds.

- The client will recognize $270,000 of capital gain ($300,000 less $30,000, his proportionate share of the basis). The client's $270,000 charitable tax deduction will offset the $270,000 of capital gain.
- Immediately following the sale:

	Example 1	Example 2
Cash in CRUT	$1,000,000	$700,000
Cash in Client's Pocket	$0	$300,000
Income Tax Due from Sale of Real Estate	$0	$0

Private Placement Life Insurance

Private Placement Life Insurance ("PPLI") can be an effective investment vehicle to eliminate income tax on investment earnings.

The cash premium paid into a PPLI policy is invested in an Insurance Dedicated Fund ("IDF"). IDF assets typically consist of hedge funds, private equity, venture capital, or other securities. It is common to "over-fund" the policy and secure the minimum level of death benefit required to qualify as life insurance.

If you want access to the assets, you can borrow from the policy's cash value as needed. At death, the death benefit passes to beneficiaries free of income tax (and possibly free of estate tax if owned by a trust that is outside the estate).

Investing in PPLI is beneficial when the return on PPLI investing (calculated after subtracting costs associated with PPLI) exceeds the return on taxable investing (calculated after subtracting income tax on the earnings).

With the potential for future income tax rate increases, investing through PPLI will be even more appealing.

Take Advantage of 300 Year Term for Trusts

In the fall of 2021, the Texas legislature enacted a new law to allow trusts to last for 300 years.

The new law applies to trusts with an effective date on or after September 1, 2021. If you create an irrevocable trust during your life, the effective date is the date the trust is created. If your Will or Living Trust provides for trusts that will be activated upon your death, the effective date will be your date of death.

Before this new law, the Texas "Rule Against Perpetuities" permitted trusts to last no longer than the lifetime of anyone alive at time of trust creation (known as a "measuring life" who was identified in the trust), plus 21 years. If such a measuring life was a baby who lived to 80, the maximum length of a Texas trust was about 100 years.

In the past, Texans wishing to create a longer-term trust created the trust under the law of another state (such as a perpetual trust in Delaware, South Dakota, or Alaska, or a 365-year trust in Nevada). To do so required naming a trustee in that chosen state. Texans desiring longer-term trusts now have the choice of keeping their trusts at home. There are still other protections that may favor creating an out-of-state trust, but if the only concern is duration, a Texas trust is now an option.

Estate planners are now exploring whether irrevocable trusts created before September 1, 2021, can be modified to last longer. That analysis needs to happen on a trust-by-trust basis, depending on the facts of each case. However, what is clear is that if your Will or Living Trust creates a Texas trust that activates upon your death, you should consider amending your plan to take advantage of the new 300-year term.

What's in the New Greenbook?

In March 2022, the Biden Administration released its budget recommendations for fiscal year 2023 and the Treasury Department released their "Greenbook" detailing proposed tax increases aimed at generating revenue to cover the budget. Following is a high-level summary of key provisions in the FY2023 Greenbook.

Modify Income, Estate and Gift Tax Rules for Certain Grantor Trusts

- Treat a grantor's payment of income tax attributable to income earned by the grantor trust as a gift to the trust. Only applicable to new grantor trusts as existing trusts will be grandfathered.
- Sales to grantor trusts no longer ignored for income tax purposes and therefore subject to tax on the gain, whether it's a sale to an old grantor trust or a new grantor trust, effective the date of enactment.
- Restrict GRATs:
  - No zeroed out GRATs. Remainder interest must be worth at least the greater of 25% of the assets transferred to the trust or $500,000 (but not more than the value of the assets transferred).
  - GRATs must last at least 10 years. Maximum term is grantor's life expectancy plus 10 years.

Reform Taxation of Capital Gains

- Tax capital gains for high-income earners at ordinary rates:
  - If taxable income is over $1 million, long-term capital gains and qualified dividends taxed at ordinary income tax rates.
- Treat transfers of appreciated property by gift or on death as recognition events:
  - Upon gift to irrevocable trust.

- On distributions from a trust.

- When a revocable trust becomes irrevocable.

- Upon death.

- On assets held by a trust, partnership, or other noncorporate entity if have not been the subject of a recognition event in the last 90 years, with first recognition event on December 31, 2030.

  - If a family-owned business, can elect not to recognize unrealized appreciation until the business is sold or is no longer family owned and operated.

- Exclusion of $5 million per person on property transferred by gift during life. Any remaining can be used at death. Unused can be transferred to surviving spouse.

- Exception for tangible personal property, excluding collectibles.

- Exception for transfer to a U.S. spouse, until the surviving spouse disposes of the asset or dies.

- Exception for transfer to a charity.

Limit Duration of Generation-Skipping Transfer Tax Exemption

- GST exemption would no longer last as long as the trust lasts.

- GST exemption would shield trust assets from GST tax only as long as the life of any trust beneficiary who either:

  - Is no younger than the transferor’s grandchild; or

  - Is a member of a younger generation but who was alive at the creation of the trust. Note it does not say “plus 21 years.”

- Existing GST exempt trusts would be considered as if created on the date of enactment.

Increase Top Marginal Income Tax Rate for High Earners

- Currently, top marginal tax rate is 37%. Under the 2017 Tax Act, the top marginal tax rate for individual income tax will be 39.6%, beginning in 2026.

- This proposal would raise the top rate to 39.6% now and would compress the tax brackets so the top rate would apply to taxable income over $400,000 ($450,000 for married couple and $425,000 for head of household).

Require Consistent Valuation of Promissory Notes

- Note receivable must be valued for subsequent transactions at same amount it was valued at time of note creation.

Impose Minimum Income Tax on Wealthiest Taxpayers

- A version of a "Billionaire's Tax."

- For taxpayers with wealth over $100 million (assets less liabilities), minimum tax of 20% of total income, with income calculated to include **unrealized** capital gains.

Raise Corporate Income Tax Rate to 28%

- Increase from 21% to 28%.

Prevent Basis Shifting by Related Parties through Partnerships

- When a distribution of partnership property results in a basis step-up for the partnership's non-distributed property (because the partnership has a Section 754 Election in effect), a new matching rule would prohibit any partner that is related to the distributee-partner from benefitting from the step-up until the distributee-partner disposes of the distributed property in a fully taxable transaction.

Tax Carried (Profits) Interests as Ordinary Income

- Treat the carried interest of partner in an investment partnership as ordinary income regardless of the character of the income at the partnership level.

- Also require partners receiving a carried interest to pay self-employment tax.

- Applicable if partner's taxable income (from all sources) exceeds $400,000.

Limit Deferral of Gain from Like-Kind Exchanges

- Limit gain deferred under Section 1031 to $1 million per year for a married couple ($500,000 if single).

Require 100% Recapture of Depreciation Deductions as Ordinary Income for Certain Depreciable Real Property

- Taxing unrecaptured Section 1250 gain as ordinary income.

Limit Use of Donor Advised Funds to Avoid Private Foundation Payout Requirement

- Private Foundations generally must distribute at least 5% of the total fair market value of their assets each year. Currently a Private Foundation can distribute this amount into a Donor Advised Fund.

- This proposal provides that a contribution to a Donor Advised Fund from a Private Foundation is not a qualifying distribution unless the funds are distributed out of the Donor Advised Fund by the end of the following taxable year.

Bonus: Proposed Regulations on Estate and Gift Tax Exemption

On April 26, 2022, the IRS published proposed regulations to further clarify the treatment of the temporarily doubled gift and estate tax exemption for decedents dying after 2025.

History

The Tax Cuts and Jobs Act of 2017 doubled the estate and gift tax exclusion amount, with a sunset date of January 1, 2026.

In 2019, the Treasury published "anti-clawback" regulations which adopted a special rule that allows a decedent's estate to use the amount of exemption that was used when the gift was made if that amount is higher than the exemption amount on the date of death. This effectively prevented a "clawback" of gift tax for gifts made when the higher exemption amount was in effect.

Proposed Regulations

The 2019 regulations were not intended to prevent a clawback in situations where gifts were not true *inter vivos* transfers but were structured to be includible in the decedent's gross estate, such as a completed gift that deliberately tripped Section 2036, because the decedent retained a level of benefit or control of the asset. The grantor's goal was to lock in the doubled exemption but retain benefit from the asset gifted.

On April 26, 2022, the IRS published proposed regulations which add a provision stipulating that the following do not qualify for the special rule that allows use of the higher exemption amount:

- Gifts subject to a retained life estate or subject to other powers or interests as described in Sections 2035 through 2038 and Section 2042, such as:

    - Assets in a trust funded by the decedent of which the decedent serves as the trustee with absolute discretion to make distributions.

    - A residence transferred by the decedent during life in which the decedent retains the right to reside until death.

- Gifts made by enforceable promise, to the extent they remain unsatisfied as of the date of death, such as:

- A gift of a promissory note payable by the donor to the done, where assets of the estate will be used to satisfy the note.

- Transfers of certain applicable retained interests in corporations or partnerships (Section 2701) or trusts (Section 2702), such as:
  - Transfers of equity interests in an entity where the senior generation retains certain preferred rights.
  - Assets in a GRAT (Grantor Retained Annuity Trust) where the decedent dies during the annuity period.
  - Assets in a GRIT (Grantor Retained Income Trust) intentionally created to reserve an income interest to the grantor and to take advantage of the higher exemption amount during the grantor's lifetime.

The proposed regulations also include transfers that would have been described in the preceding bullet points but for "fixing" a potentially abusive situation by releasing control or access to the assets or paying off the promissory note within 18 months of the date of death.

The special rule would continue to apply to transfers includible in the decedent's estate where the taxable amount is 5% or less of the total amount of the transfer, valued as of the date of the transfer.

Final regulations are not issued until the public has a period of time to make comments on the proposed regulations. The new regulations would only apply to the estates of decedents dying on or after the date the regulations are published as final.

Note that, even under the proposed regulations, gifts that do not trip Sections 2035-2038, Section 2042, Section 2701, or Section 2702 still lock in the doubled exemption and are not subject to clawback if the donor dies after 2025. Accordingly, it is still advisable to engage in "Use It or Lose It" planning by December 31, 2025.