“Last Chance” Tax Planning: The Golden Age of Estate Planning Won’t Last Forever

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Mr. Blum founded The Blum Firm, P.C. over 40 years ago. The firm specializes in estate and tax planning and the related specialties of asset protection, business planning, business succession planning, charitable planning, family legacy planning, fiduciary litigation, and guardianship. The Blum Firm has grown to be one of the premier estate planning firms in the nation, known for creating customized, cutting-edge estate plans for high-net-worth individuals.

Mr. Blum serves on the Editorial Advisory Committee for *Trusts & Estates* magazine. He is Treasurer for the Texas Cultural Trust.

Mr. Blum earned his BBA (Highest Honors) in Accounting from The University of Texas and received his law degree (High Honors) from The University of Texas School of Law.

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.
- The “Golden Age” came under risk on January 5, 2021 when Georgia’s two Senate run-offs shifted the Senate to Democratic control.
- Congress has not closed an estate planning loophole in over 30 years.
- We’re in the lowest tax regime since 1930.

Key Legislative Developments

- December 27, 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 11, 2021: American Rescue Plan became law—$1.9 trillion of spending, with no revenue in it to pay for it.

- $1.2T Bipartisan Infrastructure Bill: This summer, President Biden reached a $1.2 trillion infrastructure compromise with a bipartisan group of senators. The bill provides for spending on infrastructure (roads and bridges, etc.) but does not include much in tax increases to raise the funds for the spending. The Senate passed this "Bipartisan Infrastructure Bill" in August, and the bill is now sitting in the House waiting for a vote.

- $3.5T Build Back Better Act: Legislation intended to implement President Biden's social and educational reforms is commonly referred to as the "Build Back Better Act." It includes provisions for funding, establishing programs, and otherwise modifying provisions relating to a variety of areas, including education, labor, childcare, healthcare, taxes, immigration, and the environment.

How to Pay for It?

- Tax the rich?
- Billionaire's tax?
- $3.5 Trillion Reconciliation Bill: The House Ways and Means Committee has the tax code in its jurisdiction and has proposed tax increases to pay for the new spending, commonly called the "$3.5 Trillion Reconciliation Bill." As a budget reconciliation bill, it can pass the Senate with only 51 votes (so 50 Senators and 1 Vice President), instead of requiring 60 votes.

Pending Tax Law—What’s the Latest?

What's in the Reconciliation Bill?

1) Accelerates the sunset of the lifetime gift and estate tax exemption back to $5 million adjusted for inflation to now be effective December 31, 2021, rather than December 31, 2025. For 2022, estimated to be $6,020,000.

2) Valuation discounts no longer available when transferring entities holding "non-business assets" (passive assets not used in the active conduct of a trade or business), effective for transfers made after the date of enactment.

3) Grantor trust assets now includible in grantor's estate, applicable to trusts created on or after the date of enactment AND to any portion of a trust created before the date of enactment which is attributable to a contribution made on or after the date of enactment.

4) 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.

5) Distributions from a grantor trust now subject to gift tax if made to someone other than grantor or grantor's spouse.

6) Grantor trust status ending is now treated as a gift of the entire trust on that date, such as when a done by toggling off a defect.

7) Increases top income tax rate from 37% to 39.6%, effective for 2022 tax year, and lowers threshold for highest bracket to $450,000 for joint filers, $400,000 for single, $425,000 for head of household, $12,500 for trust or estate. (Current threshold for top bracket is $628,300 for joint filers and $523,600 for single.)

8) Increases highest long term capital gains tax rate from 20% to 25%, for gains realized after Sept 13, 2021. Also aligns income threshold to highest new ordinary income tax bracket ($450,000 for joint filers, $400,000 for single, $425,000 for head of household, $12,500 for trust or estate). For 2021, current income bracket applies.

9) Expands 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, effective for 2022 tax year.

10) New 3% surtax on modified adjusted gross income above $5 million for joint filers AND for single, above $100,000 for trusts and estates (excluding charitable trusts), effective for 2022 tax year.

11) Caps maximum allowable Section 199A 20% pass-through deduction at $500,000 for joint filers, $400,000 for single, $10,000 for trusts and estates, effective for 2022 tax year.

12) Modifies carried interest rules to increase holding period from 3 years to 5 years to be taxed as capital gain, effective for 2022 tax year.

    EXCEPTION: If adjusted gross income is less than $400,000, still get 3-year period.

    EXCEPTION: Real property trades or businesses still get 3-year period.

13) New graduated corporate tax rate structure, effective for 2022 tax year, of 18% tax rate on first $400,000 of income, 21% on income $400,001–$5 million, 26.5% on income above $5 million.

    EXCEPTION: For corporations with income over $10 million, the amount of tax determined above is increased by the lesser of (i) 3% of such excess, or (ii) $287,000.

    EXCEPTION: Personal services corporations taxed at flat 26.5% rate.

14) Limits exclusion rate for Qualified Small Business Stock gains for sales on or after September 13, 2021. For taxpayers with AGI over $400,000 and all trusts and estates, the 75% and 100% exclusion rates no longer available—only the 50% exclusion rate is available.

15) Restricts Roth conversions beginning in 2032 if income is over $450,000 for joint filers, $400,000 for single, $425,000 for head of household.

16) 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 2022 tax year.

17) 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 2022 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.

18) Prohibits IRAs from owning interests in Private Placement Investments, effective for 2022 tax year. Subject to a 2-year transition period for IRAs already holding such investments.

What's not included?

- No repeal of basis step-up at death.
- No forced recognition of gain at death.
- No limits on annual exclusion gifts.
- No repeal of SALT cap ($10,000 cap on deduction of state and local taxes).
- No limits on 1031 like-kind exchanges of real estate (limiting amount of gain deferral per year).

Planning to Do Between Now and "the Date of Enactment"

Extend the Term of Promissory Notes

- After the date of enactment, in-kind note payments will be taxable transactions (even on old “pre-enactment” notes).
- If possible, do in-kind note repayments before the date of enactment. Or, convert the notes to 25-year notes at the Long-Term AFR (1.86% for November). This gives you more time to either repay in cash or postpone the income tax from repaying in-kind.
- For new sales where you carry a note, use a 25-year term for the note instead of the typical 9-year mid-term duration.

Examine Irrevocable Life Insurance Trusts

- If the Irrevocable Life Insurance Trust (“ILIT”) is a grantor trust, contributions made after the date of enactment will cause a percentage of the trust to be includable in the taxable estate.
- Contribute substantial assets now to cover insurance premiums for coming years.
- Or, toggle off the defect so it’s no longer a grantor trust so that additional gifts can be made to the trust in the future.
- If it’s not possible to toggle off the grantor trust status, create a new non-grantor ILIT with substantially the same terms and merge the old ILIT into the new ILIT.

Create and/or Fund a Children's Trust Now

- Create an Intentionally Defective Grantor Trust ("IDGT") 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).

- If you wait until after the date of enactment, the assets will be includable in the taxable estate. To avoid inclusion, will have to create as a non-grantor trust, meaning that the trust would have to pay the income tax on the trust income.

"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.
  - Currently, 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.
  - After the date of enactment, these valuation discounts will no longer be available when transferring entities holding passive assets not used in the active conduct of a trade or business.

- 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.
  - Intentionally Defective Grantor Trusts (“IDGTs”) for the benefit of children:
    - Gifts to IDGTs before the Date of Enactment
    - Sales to IDGTs before the Date of Enactment
  - Spousal Lifetime Access Trusts (“SLATs”):
    - Gifts to SLATs before the Date of Enactment
    - Sales to SLATs before the Date of Enactment
  - 678 Trusts (also called Beneficiary Defective Trusts or “BDTs”):
    - Sales to a 678 Trust

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 trust for the benefit of the other because doing so preserves the resources for the spouses' benefit. This type of trust is often referred to as a Spousal Lifetime Access Trust ("SLAT").
- 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.
- 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.
- If you wait until after the date of enactment, the assets will be includable in the taxable estate. To avoid inclusion, will have to create as a non-grantor trust (called a "SLANT"), which is hard to do.

- 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 $11 million 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 $11 million 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 $22 million. However, after the first death, the survivor only has access to $11 million. To replace the lost assets, each SLAT could buy an $11 million 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 $11 million on the husband's life, so her access to the full $22 million 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 $11 million on the wife's life, so his access to the full $22 million isn't diminished when the wife dies.

"Tax Fence" With SLAT Planning

ASSETS INSIDE ESTATE and Subject to 40% Estate Tax and Creditor Claims

PERSONAL ASSETS
(HOUSEHOLD ITEMS, BANK ACCTS, ETC.)

RETIREMENT ASSETS
(PROTECTED FROM CREDITORS)

PERSONAL RESIDENCE
(PROTECTED FROM CREDITORS)

TAX FENCE

ASSETS OUTSIDE ESTATE and Protected from 40% Estate Tax and Creditor Claims, but still available for Husband and Wife

SLAT FOR HUSBAND
(HOLDS $11,400,000 OF ASSETS)

SLAT FOR WIFE
(HOLDS $11,400,000 OF ASSETS)

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.

› Why choose a 678 Trust?
  - The clients can remain in control.
  - The clients 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 the clients' estates.
  - The clients can have a special power of appointment to direct where the assets pass upon their deaths.
  - The assets in the 678 Trust are protected from creditors.

- 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.
  - 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 that although the withdrawal right is limited to $5,000, there is no 5 and 5 exception in the income tax code.)

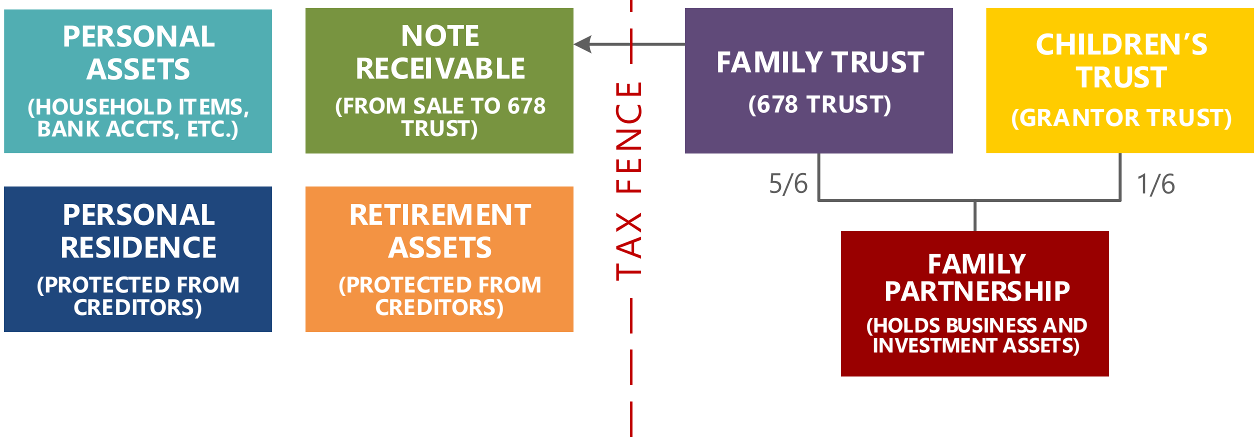
- The clients “burn down” the assets that remain in their taxable estate to pay for living expenses and to pay the income taxes generated by the 678 Trust.

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

“Tax Fence” With 678 Trust Planning

ASSETS INSIDE ESTATE and Subject to 40% Estate Tax and Creditor Claims

ASSETS OUTSIDE ESTATE and Protected from 40% Estate Tax and Creditor Claims, but 5/6 of assets still available for Husband and Wife



Fast Track “Squeeze & Freeze”

› Fast track funding the FLP by using a Nominee Agreement:
  - Instead of taking the time to transfer assets, transfer the economic equivalent of ownership without transferring title.
  - Especially beneficial if assets are difficult to retitle or transfer.

› Fast track the 30-day seasoning of FLP assets:
  - If can’t wait at least 30 days between funding the FLP and transferring the FLP interest to a trust, include someone else as a partner in the FLP with you, represented by separate counsel, so it’s a bona fide partnership.

Planning to Do Between Now and December 31

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

- To lock in the benefit of the doubled exemption before its proposed December 31, 2021 sunset date, a couple has to transfer $23.4 million out of their estate.

- Of course, if the planning includes the use of grantor trusts or valuation discounts for FLP interests, it needs to be completed before the Date of Enactment.

- If a couple decides to only give $11.7 million instead of $23.4 million, 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 $11.7 million, 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 $11.7 million, the wife will still have her "original" $5 million exemption (adjusted for inflation) after her "extra" exemption sunsets.

IRA Planning

- Convert IRAs to Roth IRAs.
  - Before income tax rates rise. The top income tax rate increases from 37% to 39.6%.
  - Before the bracket for the highest rate lowers.
    - Current threshold for top bracket is $628,300 for joint filers and $523,600 for single.
    - New proposed top bracket is $450,000 for joint filers and $400,000 for single.
  - Remember that the amount converted will be taxed as ordinary income and, therefore, could push you into a higher income tax bracket.
  - Proposed tax changes also include new 3% surtax on modified adjusted gross income above $5 million.
- Withdraw assets from a traditional IRA, pay the income tax, and make a gift of the net to a IDGT 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.

What Will be Popular in 2022?

Planning Going Forward in 2022

- Private Placement Life Insurance (“PPLI”)/Private Placement Variable Annuity (“PPVA”).
- Mixing bowl partnerships for basis shifting.
- “Freeze” sales to old grantor trusts (note that the sale will be taxable, but the appreciation escapes estate tax).
- Loans to trusts to enable the trust to invest in deals from inception.
- Planning with non-grantor trusts including non-grantor ILITs and non-grantor SLATs.
- “Squeeze” planning with trade or business assets or with undivided interests in real estate not held in an entity.
- “Upstream” gifts to elderly loved-ones to get a basis step-up when the loved-one dies and leaves the assets back to you. To avoid a one-year rule if the assets come back to you within a year, the assets should go to a trust for your benefit with a third-party trustee.

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