

San Antonio Estate Planning Council

**ESTATE PLANNING CURRENT
DEVELOPMENTS AND HOT TOPICS
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GOLDEN AGE OF ESTATE PLANNING

- ◆ Enormous Gift, Estate and GST tax exemptions
- ◆ Large valuation discounts still available
 - Failure of 2704 Regs.
 - Continued Tax Court and 5th Circuit support for discounts
- ◆ Historically low AFR to facilitate family transfers
- ◆ Grantor trust authority
- ◆ No GRAT limitations
- ◆ No claw back of lifetime gifts

WHERE ARE WE?

- ◆ The gift, estate, and generation-skipping transfer tax exclusion amount for 2021 is \$11,700,000 or \$23,400,000 for married couples.
- ◆ The annual exclusion for gifts for 2021 is \$15,000.
- ◆ The gift, estate, and generation-skipping transfer tax exclusion will revert to \$5,000,000 (indexed for inflation) on January 1, 2026.
- ◆ The IRS has estimated that there will be 4000 Forms 706 filed in 2100 with less than 10% taxable.

“FOR THE 99.5 % ACT” REFORMING ESTATE TAX

- ◆ Introduced by Senator Bernie Sanders (I-VT), Senator Sheldon Whitehouse (D-RI), and Representative Jimmy Gomez (D-CA)
- ◆ The Joint Committee on Taxation asserts the 99.5% Act will generate \$430 billion over the next decade.
- ◆ The 99.5% Act got its name because roughly 0.59% of estates are expected to be taxable in 2022.
- ◆ Some of the following changes will be effective for decedents dying, and gifts made, following bill enactment and some will be effective as of December 31, 2021.

“FOR THE 99.5 % ACT” REFORMING ESTATE TAX: HIGHLIGHTS

◆ Gift and Estate Tax Basics

- Reduce Lifetime Exemption Limits
 - ❖ Current: \$11.7 million lifetime gift and estate tax exemption
 - Functions as a unified credit
 - Scheduled to sunset to \$5 million on 1/1/2026 (indexed for inflation so, approximately \$6.4 million)
 - GST tax exemption is also \$11.7 million currently
 - ❖ 99.5% Act Proposal:
 - Estate: \$3.5 million (Note: this was the 2009 exemption)
 - Gift: \$1 million
- Increase in Estate and Gift Tax Rate and replace with a progressive rate system
 - ❖ Current: flat 40% for transfers exceeding the taxpayer's \$11.7 million lifetime exemption
 - ❖ 99.5% Act Proposal:
 - 45% estate tax rate for estates of \$3.5 million–\$10 million
 - 50% estate tax rate for estates of \$10,000,001–\$50 million
 - 55% estate tax rate for estates of \$50,000,001–\$1 billion
 - 65% estate tax rate for estates above \$1 billion
 - NOTE: 77% was the top estate tax rate in history.
- The gift tax exemption no longer subject to inflation adjusted but, the estate tax exemption would continue to be indexed for inflation (i.e., “un”-unified).
- Limit annual exclusion gifts to trusts (and passthrough entities) to \$30,000 per donor.

“FOR THE 99.5 % ACT” REFORMING ESTATE TAX: HIGHLIGHTS

◆ Modifications to Grantor Trust Rules

- Grantor trust assets included in estate of grantor
 - ❖ Except transfers to “grandfathered” grantor trusts, funded and irrevocable prior to enactment
 - ❖ Basis “step-up” eliminated for grantor trust assets not included in grantor’s estate
 - NOTE: The 99.5% Act does not eliminate other basis adjustment rules. Van Hollen’s bill imposes capital gain at death and Wyden’s bill imposes annual mark-to-market valuations.
 - ❖ Distributions from grantor trusts during life of grantor would be subject to gift tax.
 - ❖ Assets of grantor trusts would be considered a gift if/when grantor trust status “turned off.” (NOTE: This change would apply to transfers to grantor trusts existing prior to enactment).
- GRAT terms restricted:
 - ❖ Minimum: 10 years
 - ❖ Maximum: not longer than the grantor’s life expectancy +10 year
- “Zeroed-out” GRATs eliminated: Value of the (taxable) remainder must be at least the greater of 25% of the value of the contributed assets or \$500,000.

“FOR THE 99.5 % ACT” REFORMING ESTATE TAX: HIGHLIGHTS

◆ Other Alterations to the Transfer Tax System

■ Curtailing Valuation Discounts

- ❖ Nonbusiness (passive) Interests: disallowance of valuation discounts for entities holding non-active business assets, such as marketable securities
- ❖ No lack of control or marketability discounts allowed if “members of the family” have control (voting interests) and a majority of entity ownership (by value).
- ❖ Active Business Assets: value non-essential assets valued separately, without discounts.

■ Changes Application to Generation Skipping Transfers

- ❖ Imposition of new 50 year RAP.
- ❖ Assets exempt from GST tax for a maximum of 50 years (i.e., inclusion ratio becomes 1.000 50 years after enactment).
 - NOTE: GST tax is subject to the highest applicable federal estate tax rate (i.e., 65% under the 99.5% Act).

GREENBOOK BUDGET EXPLANATIONS – ESTATE AND GIFT TAX PROVISIONS

- ◆ Issued by Treasury Department in May 2021 to explain President Biden's Budget Proposals, including the American Jobs Plan and the American Families Plan.

GREENBOOK BUDGET EXPLANATIONS – ESTATE AND GIFT TAX PROVISIONS

- ◆ Raises the top individual Income Tax rate from 37% to 39.6%.
- ◆ The only change to rates is the top bracket, but it will apply at a lower income level:
 - The old 37% bracket was applicable to income over \$523,700 for single and \$628,300 for MFJ.
 - The new 39.6% bracket will apply to income over \$452,700 for singles and \$509,300 for MFJ.

GREENBOOK BUDGET EXPLANATIONS – ESTATE AND GIFT TAX PROVISIONS

- ◆ Capital Gain Tax Changes.
- ◆ This proposal would cause individuals with income over \$1,000,000 to pay a rate equal to the highest individual rate (39.6%) on capital gains and qualified dividends.
 - Example: An individual with \$600,000 of ordinary income and \$500,000 of capital gains would pay the old 20% capital gain rate on \$400,000 of capital gains and 39.6% on \$100,000.
 - Biden has indicated that this change will be effective as of the introduction of the American Families Plan which was in late April.

GREENBOOK BUDGET EXPLANATIONS – ESTATE AND GIFT TAX PROVISIONS

- ◆ Tax on Transfers during life and at death.
- ◆ This proposal would cause gifts during life and the act of dying a taxable event for Federal income tax purposes.
 - Gift Example: Client makes a gift of an asset worth \$1,000,000 and with a basis of \$600,000 to a child or a trust. This proposal would cause the recognition of the \$400,000 gain and the donee would then take a basis of \$1,000,000. Currently, of course there would be no gain recognized and the donee would take the donor's basis of \$600,000.
 - Estate Example: Client dies with an asset worth \$1,000,000 and with a basis of \$600,000. The \$400,000 of gain would be taxable to the decedent's estate. Currently, Section 1014 would cause the basis to be adjusted to \$1,000,000 and the \$400,000 would never be recognized.

GREENBOOK BUDGET EXPLANATIONS – ESTATE AND GIFT TAX PROVISIONS

- ◆ Tax on Transfers during life and at death.
- ◆ Exceptions:
 - Proposal would not be applicable transfers to spouses or charity.
 - Proposal would not be applicable to transfers of tangible personal property, except collectibles.
 - Proposal allows a \$1,000,000 per person lifetime exemption for exclusion from gain.
 - Proposal allows certain exceptions for the payment of tax on certain family-owned and operated-businesses. Tax could be deferred until business was sold or no longer family owned. There is also a provision for a 15 year deferral for tax on assets other than marketable securities and other liquid assets.

SEPTEMBER 13TH

- ◆ Raise the top personal income tax rate to 39.6% from 37%. These would apply at a lower bracket.
- ◆ 3% surtax on individuals with adjusted gross income of more than \$5 million.
- ◆ Expand NIIT to cover income derived in the ordinary course of business for wealthy taxpayers.
- ◆ Increase capital gains rates to 25%.
- ◆ Instead of a flat corporate tax rate,
 - 18% rate on the first \$400,000 of income
 - 21% on income up to \$5 million.
 - 26.5% on income above \$5 million

SEPTEMBER 13TH

- ◆ Increase tax rate on foreign income from 10.5% to 16.5%.
- ◆ \$80 billion in additional funding for the IRS to increase audits on companies and wealthy individuals.
- ◆ Restrictions on carried interest.
- ◆ Increase holding period for long term capital gain from 3 to 5 years.

SEPTEMBER 13TH

- ◆ The proposal calls for a reversion of the gift and estate tax exemption to 2017 levels (\$5,000,000 per person (Indexed for Inflation)). The effective date for this provision would be applicable to transfers after December 31, 2021.
- ◆ The proposal calls for the denial of valuation discounts (typically lack of control and lack of marketability) for all “nonbusiness assets”. Nonbusiness assets are defined as passive assets that are held for the production of income and not used in the active conduct of a trade or business. This provision is stated to become effective for transfers after the date of enactment of the Act. If unchanged, this provision could become effective well before the end of the year.
- ◆ The proposal calls for all Grantor Trusts to be included in the gross estate of the deemed owner (typically the grantor). Additionally, sales between grantor trusts and their deemed owner would be treated as sales between the owner and a third party. These changes would apply only to future trusts and future transfers, presumably after the date of enactment.
- ◆ The proposal increases from \$750,000 to \$11,700,000 the amount that certain real estate used in farming or a family business may be reduced based on its actual use versus the fair market value. This provision would be applicable to decedent’s dying after December 31, 2021.

2021 GIFT PRINCIPLES

- ◆ The (unfortunate) Name of the Game: Uncertainty
 - “Use it or Lose it”: IRS has indicated that a taxpayer’s lifetime exemption (known as the “basic exclusion amount”) amount will be the higher of his allowable use in a particular year or the applicable basic exclusion amount in his year of death.
 - Potential retroactivity of proposed legislation (most notably, provisions related to capital gain taxation)
 - Formula gifting in light of valuations and applicable remaining exemption amounts

PROACTIVE PLANNING MECHANICS

- ◆ SLATs
 - Can optimize benefits of utilizing one spouse's exemption for the benefit of the other spouse, preservation of (indirect) access to transferred assets, asset protection, management, and familial control.
- ◆ Full Use of One Spouse's Lifetime Exemption
 - Gift to a single grantor dynasty trust for children and descendants
 - ❖ Comparative example:
 - Husband makes 2021 separate property gift to dynasty trust of \$11.7 million; wife makes zero gift.
 - Result: If Husband and Wife both die in years when the lifetime exemption is \$3.5 million, the Couple's maximum tax-free transfer is \$15.2 million.
 - Husband and Wife both make 2021 gifts of \$5 million to dynasty trust(s).
 - Alternative Result: If Husband and Wife both die in years when the lifetime exemption is \$3.5 million, the Couple's maximum tax-free transfer is \$10 million (both exemptions were exhausted during life, nothing remains).
- ◆ Other
 - Completed gift to grantor trusts prior to anticipated legislative changes ("grandfathered" grantor trust under some proposed legislation)
 - Sales at historically low interest rates.

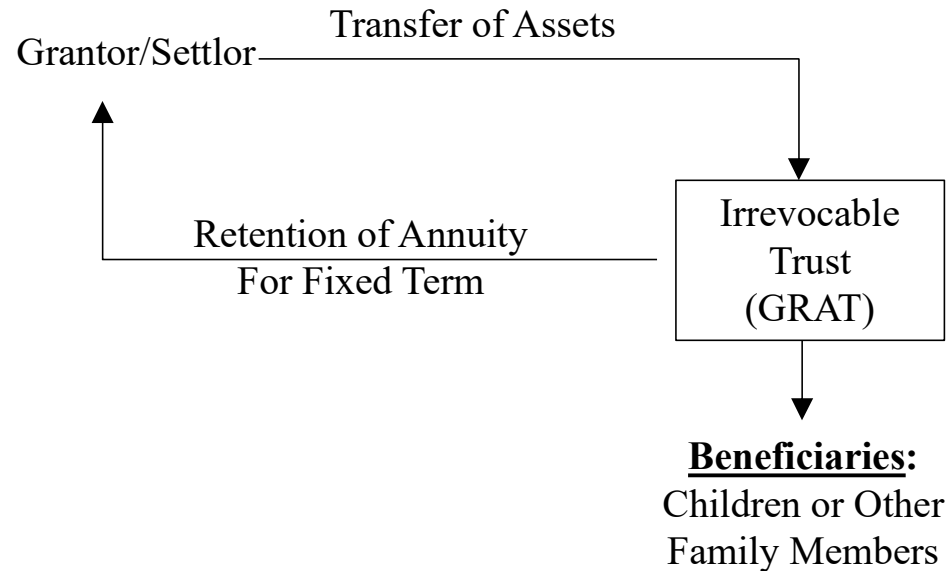
POPULAR PLANNING TECHNIQUES

- ◆ Grantor Retained Annuity Trusts (GRATs)
- ◆ Spousal Lifetime Access Trusts (SLATs)
- ◆ Sales to Intentionally Defective Grantor Trusts (IDGTs)
- ◆ Intra-Family Loans and Refinancing Existing Debt
- ◆ Gifts
- ◆ Proceed With Caution:
 - Reciprocal Non-Reciprocal Trusts
 - Section 678, Beneficiary Defective Income Trust (BDITs)
- ◆ Discounted Entities

GRAT PLANNING

- ◆ The Grantor Retained Annuity Trust ("GRAT") is a popular and powerful estate freezing technique. In a GRAT, the grantor, transfers an interest in property to a trust and retains an interest in that property in the form of an annuity, which meets certain requirements spelled out under Section 2702. The GRAT plan can be diagrammed as follows:

GRAT PLANNING



GRAT PLANNING

- ◆ In determining the value of the gifted remainder interest, the value of the annuity interest retained by the grantor reduces the value of the transferred remainder interest. The grantor has flexibility and is able to set the term of the trust as well as the amount of the annuity. Upon formation of the GRAT, the grantor makes a gift of the actuarial value of the remainder interest in the property. The value of the remainder interest depends on the term of the trust, the applicable rate under Section 7520, and the amount of the annuity. The grantor has the flexibility to increase the amount of the annuity and/or increase the length of the term of the GRAT, and this in turn will lower the value of the gifted remainder interest. The Section 7520 rate is the hurdle rate in which if the value of the assets transferred to the GRAT appreciate in excess of the Section 7520 rate, the GRAT will be successful. Moreover, the grantor must outlive the term of the GRAT in order to avoid inclusion of any of the GRAT assets and the grantor's gross estate. The grantor however, is in no worse of a position than if he had never created the GRAT. Thus, the only cost of a failed GRAT is the cost of establishing it (and perhaps an opportunity cost of foregoing other planning).

GRAT PLANNING

1. Zero-Out Planning
2. Use of a GRAT as an Estate Freezing Device
3. Estate Reduction Opportunity – Post GRAT Term
4. GST Tax Exemption cannot be allocated until end of annuity term
5. Use Short Term Rolling GRATs
6. Use Graduated Annuity
7. Use Separate GRAT for each Asset
8. Ability to cap the GRAT
9. Utilize the 105-Day Deferral Period

SPOUSAL LIFETIME ACCESS TRUSTS

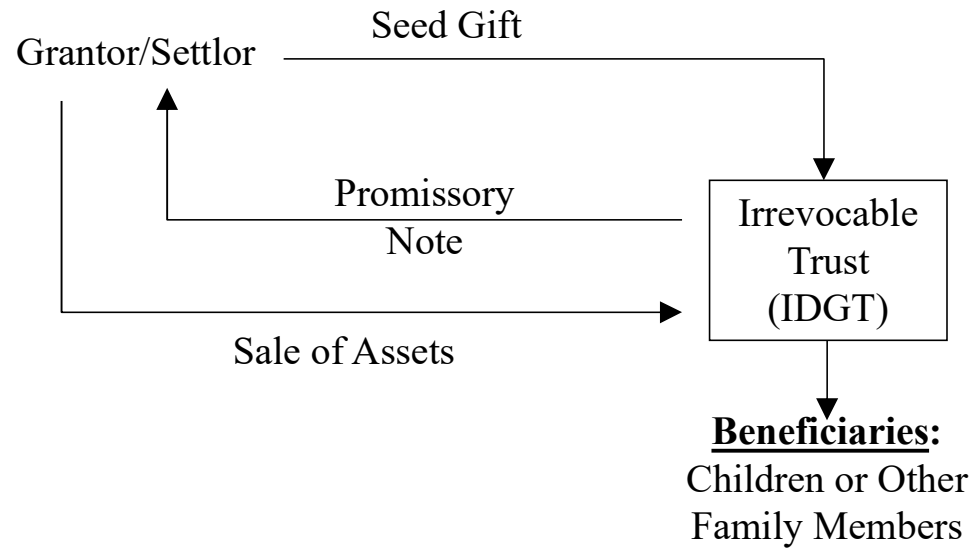
◆ The Basics

- Completed gift to a trust established for the benefit of a spouse.
- Descendants are often included as beneficiaries.
- Necessity of a Partition of community property assets of spouses.
- It is designed to be outside the estate of both the grantor and the beneficiary spouse.
- Can, and often is, established as a grantor trust for income tax purposes .

◆ Potential Risks

- Divorce issues: Completed gift to now-former spouse!
- Grantor Trust issues.
- Reciprocal trusts prohibited: Steps can be taken to minimize risk of imposition of Reciprocal Trust Doctrine but there is no safe harbor. **ATTEMPT AT YOUR OWN RISK.**

SALE TO IDGT



IDGT PLANNING

The IRS issued Revenue Ruling 2008-22 indicating that the substitution power will not cause estate inclusion under Section 2036 or Section 2038 provided:

(i) the trustee has a fiduciary obligation to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are, in fact, of equivalent value (generally state law provides for this), and

(ii) further provided that substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

IDGT PLANNING

◆ **Structuring the Sale – Planning Tips**

- Purchase Price - always get an Appraisal
- Installment Sale - carefully consider the Length of the Note
- Interest Rate - Timing of Closing
- Develop Economic Model
- Secure the Note

IDGT PLANNING

◆ Comparison of GRAT v. Sale to IDGT

	GRAT	IDGT
1. Survival	Yes	No
2. Interest Rate	Higher	Lower
3. GST Allocation	No	Yes
4. Statutorily Recognized	Yes	No
5. Seed Gift	No	Yes

INTRAFAMILY LOANS

- ◆ At current interest rates, a simple intrafamily loan is a good method for older generation to provide the younger generation with capital without making a taxable gift. The note must carry appropriate interest to avoid gift tax consequences. If interest is not paid, the lender is deemed to have received interest income (pays tax on it) and deemed to have made a gift of that amount to the borrower.

INTRAFAMILY LOANS

- ◆ Interest rate must only be paid (or accrued) at the AFR. [Note: The OID Rules (original interest discount) may apply if the interest is accrued and not paid currently, requiring the lender to report interest income currently...but at least there will not be a gift under the 7872 rules]. If the lower generation can invest the borrowed funds that provides a return in excess of the AFR, the intrafamily loan may be an effective estate planning tool.

INTRAFAMILY LOANS - GUIDELINES

- ◆ Whether there's a true loan is a question of fact. Several factors help determine whether a transfer creates a bona fide debt:
 - the name given to the instrument underlying the transfer of funds;
 - the presence or absence of a fixed maturity date and a schedule of payments;
 - the presence or absence of a fixed interest rate and actual interest payments;
 - the source of repayment;
 - the adequacy or inadequacy of capitalization;

INTRAFAMILY LOANS - GUIDELINES

- the identity of interest between creditors and equity holders;
- the security for repayments;
- the transferee's ability to obtain financing from outside lending institutions;
- the extent to which repayment was subordinated to the claims of outside creditors;
- the extent to which transferred funds were used to acquire capital assets; and
- the presence or absence of a sinking fund to provide repayment.

INTRAFAMILY LOANS - REFINANCING

- ◆ Refinancing family debt in a low interest rate environment makes perfect planning sense. Refinancing too often may factor into whether the debt is bona fide. Any refinancing should consider the following:
 - The fundamentals of the family debt are solid after applying the guidelines above; and
 - There is consideration to the lender to refinance at a lower rate such as:
 - ❖ reduced principal through repayment, shorter maturity date, additional collateral, and/or a faster amortization schedule.

DISCOUNTED ENTITIES - SECTION 2036 ISSUES

- ◆ Most litigated transfer tax issue with almost 40 reported cases.
- ◆ Question is whether assets contributed to an FLP or LLC should be included in the estate under Section 2036.
- ◆ Does away with the discount for restrictions applicable to a limited partnership interest.

DISCOUNTED ENTITIES - SECTION 2036 ISSUES

- ◆ IRC Section 2036 Transfers with Retained Life Estate

General Rule – The value of the gross estate shall include the value of all property, to the extent of any interest therein, of which the decedent has at any time made a transfer (except in the case of a bona fide sale for adequate and full consideration in money or money's worth) by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not, in fact, end before his death – (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

DISCOUNTED ENTITIES - SECTION 2036 ISSUES

Bona Fide Sale for Full Consideration Defense

- **Bona Fide Sale Test.** Creating an entity for tax reasons is okay as long as there is a legitimate and significant nontax reason for creating the entity.
- **Full Consideration Test.** The interest received by the parties making contributions to the entity should be proportionate to their contributions, and the value of the contributed property should be credited to capital accounts.

DISCOUNTED ENTITIES - SECTION 2036 ISSUES

- ◆ **Agreement of Retained Enjoyment Argument.** Using Section 2036(a)(1), the IRS has argued that transferred assets should be included in the estate due to an implied agreement of retained enjoyment.
- ◆ Using Section 2036(a)(2), the IRS has argued that the decedent has enough control regarding the FLP/LLC to designate who could possess or enjoy the income or property contributed to the entity.

DISCOUNTED ENTITIES - CASES

- ◆ Stranqi (2003) Tax Court cited both 2036(a)(1) and 2036(a)(2). Introduced concept that 2036 could be applied in something other than an “implied retention of benefits.” 5th Circuit affirmed on the 2036(a)(1) grounds, but the 2036(a)(2) Tax Court language is still out there.
- ◆ Powell (2017) Tax Court again considered the 2036(a)(2) grounds and again held that given the bad facts that 2036(a)(2) would cause inclusion because Mrs. Powell retained the right, alone or in conjunction with any person, to designate the persons who shall possess the property.
- ◆ Cahill (2018) Again, the Tax Court in this case involving a Split-Dollar life insurance plan represents another case invoking the 2036(a)(2) power, alone or in conjunction with any other person, to designate who shall enjoy the property.

DISCOUNTED ENTITIES - CASES

- ◆ Howard V. Moore vs. Commissioner (2020) An aggressive bad facts case. No planning commenced until decedent was terminal with six months to live, in that time decedent managed to establish an FLP, Foundation, CLT, Revocable and Irrevocable trusts and large intrafamily loans. And although not in every bad fact case, of course the decedent transferred his residence (in this case the family farm, where he lived) into the FLP. Tax Court cited both 2036(a)(1) and 2036(a)(2).

STRESS TESTING THE ESTATE PLANNING

- ◆ The most litigated transfer tax issue of IRC Section 2036 where the IRS argues that although assets are transferred, there is an implied agreement of retained enjoyment or control and the assets should be included in the estate.

STRESS TESTING THE ESTATE PLANNING

- ◆ Now is the time to stress test the planning and blunt the arrows in the IRS's quiver:
 - Have gift tax returns been filed and do they adequately disclose the gifts?
 - Have all the income tax returns been filed?
 - Do the tax returns, transfer documents and appraisals match?
 - Are the entities in good standing?
 - Are the clients respecting the legitimacy of the entities and following formalities?
 - Is the client relying on distributions from the entity or is it making disproportionate distributions?
 - Is the client commingling personal assets with entity assets (“living out of the partnership”) or using partnership assets (vacations at the Aspen condo and Maui pad)?
 - Are there transfer documents evidencing contributions to the entity?

STRESS TESTING THE ESTATE PLANNING

- ◆ Continued stress test planning:
 - Have you documented the non-tax purposes for the entity?
 - Have you documented adequate and full consideration for the issued entity interests?
 - ❖ Contribution Schedule
 - ❖ Ownership Percentages
 - ❖ Capital Account Ledgers
 - Does client have books and records for the entity?
 - Are utilities in name of entity?
 - Are property taxes and other expenses being paid by the entity?
 - Is property liability insurance being paid by the entity?

STRESS TESTING THE ESTATE PLANNING

- ◆ Continued stress test planning:
 - Is there any personal use of entity property?
 - Is there any commingling of entity assets?
 - Has client retained assets for own support and maintenance?
 - Do the partners conduct an annual meeting and prepare minutes?
 - If children or trusts own entity interests, have gift tax returns been filed?
 - Are there prior sales or other non-gift transactions that have not been disclosed on prior returns?
 - Agent will request statement for operating accounts and search for non-disclosed gifts.

STRESS TESTING THE ESTATE PLANNING

- ◆ Continued stress test planning:
 - Are parents supporting adult children?
 - Does client have Crummey letters for gifts?
 - If no Crummey letters, can you establish actual knowledge of gifts by beneficiaries?
 - Does a buy-sell agreement set a value or contain a put or call right?
- ◆ If no, what can we do to backfill and fix the problems before it is too late?

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Joel counsels businesses, wealthy individuals and families about their most demanding tax planning, estate planning and IRS controversies. He often works with tax professionals and financial specialists to help develop solutions for their clients. Joel is a Partner in the firm and is Board Certified in Tax Law by the Texas Board of Legal Specialization.

Joel has been recognized as one of the best in his field by Texas Monthly and Law and Politics Magazines by being named a Texas Super Lawyer from 2003 through 2020. He has also been named one of the Best Lawyers in Dallas by D Magazine for the year 2012-2021 and he has also been named to Best Lawyers in America for Tax Law. Joel has been recognized as a Top Rated Lawyer in White Collar Defense Law by ALM as published in the American Lawyer, Corporate Counsel and The National Law Review.

Joel is a frequent speaker on procedural and substantive tax issues for legal and accounting professionals. Some of his topics include: Tax Shelter Defense, IRS Examinations, Appeals, Litigation and Collection Strategies, IRS Criminal Investigations, IRS Offshore Activities, IRS Focus on Tax Professionals, Employment Classification, IRS Penalties, and Litigation Partnership Tax Cases. He has also published various articles regarding the IRS and tax procedures.

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