Estate Planning Insights

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THREE HOT TOPICS

Hot Topics. Originally, we planned to discuss just one of the three "Hot Topics" in this newsletter. However, because so much is going on in the estate planning, probate and transfer tax world, we decided to provide at least *some* information on all three topics.

Topic #1: Property Insurance Issues. In a recent case, a divorced man who owned a home executed and recorded in the deed records a "Lady Bird Deed" in which he retained the right to live in his home for the rest of his life, but provided that, upon his death, his home would be distributed directly (i.e., without going through probate) to his niece. Shortly after the man died, the man's ex-wife burned down the home. The insurance company denied coverage because of the definition of "the Insured" in the homeowner's insurance policy. The man himself had insurance coverage on the property while he was living, but neither the niece nor the man's "estate" had coverage after the man's death based on the definition of "the Insured" in the insurance contract. Note that the Lady Bird Deed actually prevented the home from being an asset of the man's probate estate. Thus, the niece who inherited the home was "out of luck."

<u>Important Point</u>: Insurance contracts are *contracts*, which means the specific terms of the contract, including the definition of "the Insured" in the contract, are controlling. Some of our clients have conveyed their home to a revocable trust. And some of our clients are serving as the Trustee of an irrevocable trust that owns a home that was previously owned by a person who is now deceased. In each case, it is vitally important to evaluate the definition of "the Insured" in the insurance contract applicable to the property held in the trust.

Topic #2: Multi-State Issues. Many of our clients, all of whom are legally domiciled in Texas, own real property in another state. They may own that non Texas real property in their individual name(s) or through a trust or through an LLC or other legal entity. Whenever Texans own real property in other states, a whole host of legal and tax issues must be considered. Here is a list of just *some* of those issues:

1. Income taxes may be payable to the state where the real property is located (either due to income earned by the property or the amount of time spent residing in the property located in the other state).
2. State death taxes (i.e., inheritance taxes and/or estate taxes) may be payable to the state where the real property is located upon the owner's death.
3. Upon death, a probate process may be required in the state where the non Texas real property is located. About thirty states have a "complicated" probate process that most people will want to plan to avoid.
4. Marital property characterization issues relating to the real property located in the other state are tricky. The majority of US states are *not* community property states and, therefore, even if a Texas married couple's community property is used to purchase the real property in the other state, the real property may not be considered community property pursuant to the laws of the state where the property is located. The marital property characterization of assets is vitally important when the marriage terminates, whether the marriage terminates by death or divorce.
5. Federal income tax basis issues can be affected by the location of the non Texas real property. If the real property in the other state is *not* considered to be community property, then the so-called "double step up in basis" will not be available to the property on the first spouse's death. Only the deceased spouse's one-half will get the step up. (Of course, the step up in basis may be eliminated by Congressional action anyway–see our discussion, below, in Topic #3).
6. Another "multi-state issue" concerns a "non-grantor trust" where the Trustee (or, one of the Trustees) is a resident or domiciliary of a state that taxes trust income on the basis of the residence (or domicile) of the Trustee. A typical example of a non-grantor trust would be a Bypass Trust, but this issue applies to any irrevocable trust that is not treated as a grantor trust for federal income tax purposes. At last count, at least

eleven states taxed trust income based on the residence (or domicile) of the Trustee (or one of the Trustees). So even though the settlor (creator) of the trust may have been domiciled in Texas when the trust was created and even though the trust itself may be deemed to be a "Texas trust," another state can tax that trust on its income due to the residence (or domicile) of the Trustee. Some states also impose income tax based on the residence of the beneficiaries of the trust. In addition, in certain cases, other persons with powers over the trust can be considered "fiduciaries" even if not serving as Trustee and that can trigger state income taxes on the trust's income based on the residence (or domicile) of those persons.

Important Point: Just because you live in Texas doesn't mean the laws of other states might not apply in certain cases. When Texans own property in other states they need to consider the "multi-state issues" that might affect them and their beneficiaries.

Topic #3: Transfer Tax and Related Proposals.

Clarification. Before we discuss some pending proposals to change the estate, gift, and GST tax rules and certain income tax rules, we want to clarify something that may have been implied in our prior newsletter. While the amount of the estate and GST tax exemption in 2009 was $3.5 million (as indicated in our prior newsletter), the gift tax exemption amount in 2009 was only $1 million. In one of the pending tax bills,"For the 99.5% Act," the sponsors are proposing an estate (and GST) tax exemption amount of $3.5 million and a gift tax exemption amount of $1 million. "Just like in 2009."

We started thinking about what a $1 million exemption means today, compared to what it meant in 2009. Based on one source, a $1 million gift tax exemption amount in 2021 only shelters about 81.3% (or $813,000) compared to what a $1 million gift tax exemption sheltered in 2009. Therefore, saying that "we are going back to the same exemption amounts we had in 2009," might be literally true, but the effect is not the same. There are many other economic factors that can be discussed in this regard (which we will not go into). Suffice it to say, we think a $1 million gift tax exemption is too low, especially if that amount is not going to be indexed for inflation.

Pending Tax Bills. There are multiple pending tax bills. In this newsletter, we will focus primarily on certain provisions in Senator Sanders' bill titled, "For the 99.5% Act" (the "99.5% Act"). Keep in mind that these are only *proposals*. Some provisions in the 99.5% Act:

Exemption Amounts:

Estate tax exemption: $3,500,000 (not indexed for inflation).

Gift tax exemption: $1,000,000 (not indexed for inflation).

GST exemption: Not mentioned. Assume $3,500,000 (not indexed for inflation).

As proposed, the above exemption amounts would become effective January 1, 2022.

Estate Tax Rates:

Size of Estate	Rate
$3.5 - $10 million	45%
$10 - $50 million	50%
$50 million - $1 billion	55%
≥ $1 billion	65%

Note: The GST tax is imposed at the highest rate.

Annual Exclusion Gifts:

The annual exclusion from the gift tax is currently $15,000. This is the $10,000 annual exclusion amount, with inflation adjustments. Each donor (gift giver) can give to each donee (gift recipient) cash or other assets having a total value in one year of $15,000 (or less) as a "tax-free gift" as long as the gift is considered to be a gift of a "present interest" and not a "future interest." A *present interest* basically means "an unrestricted right to the immediate use, possession, or enjoyment of property or the income from property." (Remember that the term *property* used in the tax laws means all kinds of property [assets], not just real property.) Under current law, the annual exclusion is adjusted for inflation, but only when inflation adjustments produce an adjustment of $1,000.

The 99.5% Act is proposing certain changes relating to annual exclusion gifts, starting in 2022:

The annual exclusion amount will remain at $10,000, indexed (this is what produces the current $15,000 exclusion), per donee for **outright** gifts of cash and marketable securities. BUT, the donor will be limited to a total of $30,000 per year (indexed) for gifts made to irrevocable trusts, gifts made of interests in passthrough entities (such as LLCs and LPs), and gifts that are subject to a prohibition on sale or immediate liquidation. This is a per-donor limitation. This per-donor limitation will adversely affect how most irrevocable life insurance trusts (ILITs) are funded. Strangely, the present interest requirement may not apply to these types of gifts.

The tuition and medical exclusion gift provisions would not be changed.

Portability: The 99.5% Act would keep portability. As we have discussed before, in the case of a married couple, when the first spouse dies (the "deceased spouse") and leaves all or any part of his assets directly to the surviving spouse or to a marital trust for the surviving spouse, the deceased spouse is "not using" any of his exemption on that transfer (because of the marital deduction). Not using an exemption can be viewed as "wasting" an exemption (and can lead to estate taxes ultimately being paid that otherwise could have been avoided). However, if the executor of the deceased spouse's estate timely files a federal estate tax return (Form 706) and makes the portability election, the deceased spouse's unused exemption (the "DSUE Amount") can be transported to the surviving spouse, giving the surviving spouse additional exemption that can be used with respect to taxable gifts made during life, as well as transfers made upon the surviving spouse's death.

Dynasty Trusts: New trusts that are designed to continue for multiple generations (e.g., children, grandchildren, great-grandchildren) created after the date of enactment will be deemed to be fully subject to the GST tax, from inception, if the trust can last for more than 50 years. Even dynasty trusts created *before* the date of enactment that were GST-exempt will become subject to the GST tax at the end of 50 years from the date of enactment.

GRATs: A GRAT *created after the date of enactment* would have to have a minimum term of at least 10 years. In addition, the value of the GRAT remainder interest would have to be equal to at least 25% of the value of the assets contributed to the GRAT or $500,000, whichever is greater.

Grantor Trusts: Intentionally defective grantor trusts (IDGTs) have been a mainstay of estate tax planning for years. Many trusts established by the grantor during her life for the benefit of her children and grandchildren are IDGTs. If properly structured and administered, the assets held in the IDGT when the grantor dies are not included in the grantor's estate for federal estate tax purposes. At the same time, as long as the IDGT remains a "grantor trust" for federal income tax purposes, the grantor is treated as the owner of the trust for federal *income* tax purposes. That means the grantor must pay the income taxes on all income earned by the assets held in the IDGT. This payment of the trust's income taxes by the grantor is not a gift under current law, although it has the effect of a gift and allows the value of the IDGT to increase in value more rapidly because the IDGT is not reduced by the payment of income taxes on the income earned by its assets. In addition, the grantor's payment of income taxes on the IDGT's income reduces the size of the grantor's estate for federal estate tax purposes. Further, the grantor can sell assets to the IDGT and no gain is recognized on that transaction because, for federal income tax purposes, the grantor is deemed to be the owner of the IDGT (i.e., the grantor is "on both sides" of the transaction).

In the case of IDGTs *created after the date of enactment*, if the trust is still a grantor trust when the grantor dies, the assets held in the IDGT will be included in the grantor's estate at death, valued at fair market value, with the taxable amount reduced only by *taxable* gifts made to the trust by the grantor during her life. In addition, *after the date of enactment*, distributions from IDGTs to the trust beneficiaries during the grantor's life will be considered gifts. Further, *after the date of enactment*, if the grantor releases the grantor trust power during life, that will be treated as a gift. (It is not clear if this applies to IDGTs already in effect prior to the date of enactment.) IDGTs already in effect supposedly would avoid this treatment as long as the grantor does not contribute new assets to the trust and/or engage in a sales transaction with the trust after the date of enactment.

Valuation Discounts: There will be no discount in value for transfer tax purposes in the case of transfers of "nonbusiness assets." Nonbusiness assets are assets not used (or necessary) to the conduction of an active trade or business. In addition, in the case of transfers to family members (including trusts for family members), there will be no discounts for lack of control or for lack of marketability.

Step Up in Basis: The 99.5% Act does not include any provisions relating to the step up in basis, but other proposals, H.R. 2286 introduced in the House and the STEP Act introduced in the Senate, do. Except for stated exemption amounts, these proposals would eliminate the step up in basis at death and would eliminate the carryover basis for lifetime gifts. Thus, to the extent applicable, a capital gains tax would be triggered at death on the transfer of appreciated assets

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and imposed on gifts of appreciated assets made during life. So, these transfers would be treated like sales. As currently written, if the STEP Act passes, it would be effective for transfers after December 31, 2020 (i.e., retroactive to January 1, 2021).

President Biden's American Family Plan: Among these proposals, the top income tax rate would again be set at 39.6%. Households with income over $1 million would pay ordinary income tax rates (versus long term capital gains tax rates) on long term capital gains and on qualified dividends. This plan also eliminates the step-up in basis at death for gains above $1 million ($2.5 million per couple when combined with existing real estate exemptions). The plan contains numerous other provisions designed to increase tax revenue, but does not address the estate and gift tax exemption amounts.

IMPORTANT NOTE: We do not know which proposals will actually become law and do not know the effective date of the proposals that do become law. Some may become law on January 1, 2022, some may become law immediately upon enactment and some may become law as of January 1, 2021 (as proposed in the case of the STEP Act). If the STEP Act becomes law and is effective January 1, 2021, in the case of decedents who have died in 2021, Executors of estates and Trustees of post-death living trusts may have liability exposure for making distributions to beneficiaries before it is known whether a capital gains tax will be payable with respect to the appreciated assets owned by the decedent at death.

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Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above, or by email sent to:

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