Estate Planning Insights

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Democratic Control of Congress and the Presidency: What Will Happen Now and What Should You Do?

Election Results and Democratic Proposals. By now, everyone knows that, due to the November elections and the January Senate run-off elections in Georgia, Joe Biden has been elected President, Kamala Harris has been elected Vice President, and the Democrats have reached 50 Senators in the US Senate (including Independents who caucus with the Democrats). In the event of a tie in the Senate, the new Vice President, Kamala Harris, will cast the tie-breaking vote. Thus, the Democrats are able to pass the type of legislation that can be passed with a simple majority vote (such as a budget reconciliation bill). Of course, per current law, to pass many other types of bills in the Senate would require 60 votes. However, that rule could be changed.

Will the Democrats pass a tax bill in 2021? If so, will that tax bill include provisions relating to estate, gift and Generation-Skipping Transfer (GST) taxes? If a tax bill is passed in 2021, will it be made retroactive to January 1, 2021, or will it be made effective prospectively–say, January 1, 2022? Other possibilities include an effective date as of the date the bill is signed into law or an effective date as of the date the bill was first introduced. No one knows the answers to these questions.

One serious problem with making a change in the estate tax exemption (in particular) retroactive to January 1, 2021, is that, by the time the new law is passed, many people will already have died during 2021 and, in some cases, the assets belonging to the estates of those decedents will already have been distributed to the beneficiaries, possibly without any "hold back" by the executor or trustee for potential estate taxes.

If the Democrats pass a tax bill that contains provisions relating to estate, gift and GST taxes, what would those provisions look like? No one knows the answer to that question either. (Note: We will sometimes refer to estate, gift and GST taxes as "transfer taxes.")

It is probably prudent to expect some sort of tax bill during Joe Biden's term in office. It would also be prudent to expect the exemption from estate, gift and GST taxes to be reduced (perhaps not to the same extent for each of those taxes). One exemption amount that has been proposed by some Democrats is $3.5 million. Compare that to the exemption amount currently in effect: $11.7 million. The $11.7 million exemption is the basic exclusion amount of $10 million, adjusted for inflation, that was put into law by the Tax Cuts and Jobs Act passed in December 2017. By "taking appropriate action" (it's not "automatic"), a married couple would have two exemptions. Remember: The law already on the books will sunset at the end of 2025 and, starting in 2026, the basic exclusion amount will be $5 million, which will be adjusted for inflation.

And what about the applicable tax *rate*? The current tax rate for estate, gift and GST taxes is 40%. However, some Democratic proposals would increase the tax rate to 45% (or even higher). When would this tax rate increase be effective? Again, we don't know.

It does seem that reducing the transfer tax exemption and making it retroactive to January 1, 2021 is patently unfair. For example, suppose a person makes a gift in the first quarter of 2021 that is fully covered by that person's exemption at the time when made (no gift taxes are payable) but, when the exemption is reduced in the third quarter of 2021 and made retroactive to January 1, 2021, a significant portion of that gift becomes taxable and now gift taxes are payable. That situation seems different from increasing the tax rate and making that tax rate increase retroactive. If someone makes a gift in the first quarter of 2021 that is taxable (i.e., gift taxes are payable on that gift) and, because of legislation later in the year, the amount of taxes payable is increased, that person was already expecting to pay taxes to begin with and so the retroactive change is not as "shocking" as in the first case. Note that in a US Supreme Court Case involving estate and gift tax rates, the court ruled that applying the increased tax rates retroactively was not unconstitutional. We do not know of a case involving retroactive reduction in the exemption amount.

Another Democratic proposal is to eliminate the "step up in basis" at death. This refers to the adjustment to the tax basis (sometimes also referred to as the "cost basis") of each capital asset in which the decedent owns an interest at death. A capital asset is an investment-type asset *not* held inside a "pre-tax account" (such as inside a pre-tax IRA). Typical examples of capital assets include real property, business interests, stocks, bonds and mutual funds. For federal estate tax purposes, each asset in which the decedent owns an interest at death is valued at its fair market value as of the decedent's date of death (or, in some cases, as of the "alternate valuation date"). In the case of a capital asset, that value becomes the new tax basis of that asset. This adjustment to tax basis is not always a "step up in basis" because an asset could depreciate in value so that, when the decedent dies, the asset is worth less than its pre-death basis. However, in many cases, capital assets do appreciate in value over time, so that the fair market value of those assets when the decedent dies is higher than the tax basis of those assets prior to the decedent's death. That results in a "step up in basis" at death.

Under current law, if a capital asset attains a step up in basis to its fair market value as of the decedent's date of death, that "wipes out" all prior capital gain. In general terms, when a capital asset is sold, the gain or loss on the transaction is determined by subtracting the tax basis from the sales price. Suppose a person inherits a capital asset from the decedent worth $100 as of the decedent's date of death, which had a tax basis of $60 before the decedent's death. He could sell that asset after the decedent's death for $100 (its fair market value) and not have to pay any capital gains taxes. In other words, he would not pay capital gains taxes on the $40 difference between the date of death value of the asset ($100) and its $60 tax basis prior to the decedent's death.

The step up in basis is even more valuable if no federal estate taxes have to be paid on the decedent's death. That happens, frequently, in the case of married couples, where, due to the type of estate planning that is done, no estate taxes are payable on the death of the first spouse. That also happens when the taxable value of the decedent's estate is less than the exemption amount.

If the appreciated capital asset owned at death is community property, not only does the decedent's community property one-half interest in the asset obtain the step up in basis upon his death, but the surviving spouse's community property one-half interest in the asset also obtains the step up in basis on the decedent's death. This is an income tax advantage that married couples living in community property states have with respect to community property capital assets that married couples living in common law states do not have. Even in Texas, however, there is no step up in basis for the separate property capital assets owned by the surviving spouse when the decedent dies.

What will happen if the step up in basis at death is eliminated? Will the person who inherits the capital asset have a "carryover basis" in the asset (i.e., the same basis in the inherited asset the decedent had prior to his death)? That is one possibility. In our example, that would mean the inheritor would retain the decedent's $60 tax basis in the inherited asset. Note that carryover basis is the rule that already applies to assets given away by the donor during his life. Some countries, notably Canada, impose a capital gains tax at death on the difference between the fair market value of the asset as of the decedent's date of death and the tax basis of the asset immediately prior to the decedent's death. That's also a possibility. At this point, all we have heard is that the step up in basis will be eliminated.

Downsides of Reduced Exemption Amounts. Obviously, if the estate, gift and GST exemption amounts are reduced, more estates will owe estate taxes upon the decedent's death and more gifts made during life will require the actual payment of gift taxes. More transfers will also be subject to the GST tax. But there is another downside of reduced exemption amounts besides additional tax exposure. People who have a moderately-sized estate (who often do not think of themselves as wealthy or as having a "taxable estate" or needing to do tax planning) will have to consider how best to do estate planning to avoid or reduce estate taxes. We had this situation before–back in the years when the exemption from the estate tax was less than $1 million. Even when the exemption amount finally reached $1 million in 2002, a lot of people still had to do tax planning as part of estate planning. Unfortunately, many people do not understand how the estate tax works. In addition, many people do not understand how the gift tax works with the estate tax. So, if the exemption amounts for these taxes are reduced, estate planning will become "complicated" again for many people who do not even think of themselves as wealthy or having a taxable estate.

Very Simple Explanations. As a refresher, we are going to provide very simple, general explanations of the estate tax, gift tax and GST tax in this section.

Estate Tax. The estate tax is a tax on the transfer of assets at death. The US Constitution prohibits the federal government from levying a direct property tax on its citizens. Although the estate tax is like a property tax in that it is based on the fair market value of the assets owned by the decedent at the time of his death, the estate tax is only triggered when an asset is *transferred* at death. Thus, the US Constitution is not technically violated because the estate tax is an excise tax on the decedent's ability to transfer assets, rather than a direct tax on the assets owned at death. Thus, the burial plot that was owned by the decedent, in which the decedent's remains are buried, is not subject to the estate tax because the decedent is not transferring that asset to someone else upon his death. He is using it himself!

Remember: *The IRS does not care what method of transfer is used to transfer assets at death.* If the decedent owned an interest in an asset at the time of his death and if that interest is being transferred to a new owner as a result of his death, that transfer is the type of transfer that is subject to the estate tax. As a reminder, there are basically four (4) methods that can be used to transfer assets at death:

1. Will.
2. Revocable (living) trust.
3. Beneficiary Designation "Form" for "beneficiary designation assets" (life insurance, employee benefit plans, IRAs and annuities).
4. Multi-Party Arrangement for accounts and assets other than beneficiary designation assets (such as property or accounts titled or set up to include one of the following arrangements: joint tenants with right of survivorship [JTWROS], Pay on Death [POD], and Transfer on Death [TOD]).

Methods 2, 3 and 4 are "non probate transfer methods." But, as noted above, one does not avoid estate taxes by "avoiding probate." The *method of transfer* is irrelevant when it comes to federal estate taxes.

Because the estate tax is based on the fair market value of the decedent's interest in assets being transferred upon his death, it is, in essence, a "principal tax" (as opposed to an income tax). A principal tax is worse than an income tax and much worse than a capital gains tax. Many people complain about paying capital gains taxes. However, a capital gains tax is "merely" a tax on the *gain* recognized on the sale of a capital asset (difference between sales price–i.e.,fair market value–and tax basis). In contrast, the estate tax is based on the full fair market value of the asset being transferred at death. The estate tax rate is also much higher than the current long term capital gains tax rate.

There are deductions that can be used to reduce the estate tax, such as the marital deduction and charitable deduction. Deductions are also allowed for funeral expenses, debts and estate administration expenses. In order to understand how the estate tax works in cases where the decedent made taxable gifts during life, we will next discuss the gift tax.

Gift Tax. The federal gift tax is really not well understood by most people. Like the estate tax, the gift tax is an excise tax on the transfer of assets from one person to another. In the case of the gift tax, the person making the transfer (donor) is transferring the asset during his life. The estate tax and the gift tax are designed to work together. In other words, taxable gifts made during life use up the donor's gift tax exemption, which means the donor will have that much less estate tax exemption available to his estate when he dies. The reason the estate and gift tax are part of a unified transfer tax system is that, from a policy standpoint, it should not matter whether the donor transfers everything he owns the day before he dies (as a gift) or the day after he dies (as an estate transfer). There are, in fact, some real differences between lifetime gifts and transfers at death, but a primary mistake people make in regard to the gift tax is thinking that they do not have to report taxable gifts if the current value of their estate is less than the current estate tax exemption amount. That simply is not true. Every taxable gift must be reported in a federal gift tax return (Form 709).

So what is a "taxable gift"? In general, a taxable gift is a gift that either (i) does not qualify for any of the exclusions from the federal gift tax or (ii) has a value in excess of the annual gift tax exclusion. The annual exclusion is an important exclusion from gift tax. It's an amount the donor may give to each recipient (donee) in a particular year free of gift tax. The gift tax annual exclusion amount for 2021 is $15,000. This amount is adjusted for inflation periodically, but the adjustment is only made when it will result in at least a $1,000 increase. Thus, a married couple can give $30,000 per donee free of gift tax in 2021. The Democrats have proposed limiting the total amount a donor may give away each year as annual exclusion gifts.

To meet the requirements of an annual exclusion gift, the gift to the donee must constitute a "present interest." Gifts to most trusts are normally "future interests," which means that most gifts to most trusts would not qualify for the annual exclusion unless the beneficiary of the trust is given the right to withdraw the gifted amount for a period of time. This withdrawal right is called a "*Crummey* withdrawal power" based on a federal tax case.

Two other types of gifts are excluded from the gift tax: (a) payment of the donee's tuition and (b) payment of the donee's medical bills. There is no dollar limit on these tax-free gifts, but the donor must make the payment directly to the provider to qualify for these exclusions.

In addition to the tax-free gifts discussed above, everyone has a lifetime gift tax exemption. In general, the donor does not have to *pay* any gift taxes until the taxable gifts he has made exceed, in the aggregate, his lifetime gift tax exemption. The lifetime gift tax exemption for 2021(as of this date) is $11.7 million.

Example: Dad gives Son, who is an adult, a total of $100,000 in 2021. The first $15,000 of that gift qualifies for the annual exclusion. However, the remaining $85,000 of that gift is a *taxable gift* that must be reported in a federal gift tax return. Will Dad pay gift taxes on that gift? No, because Dad has never used any of his lifetime exemption from the gift tax. Therefore, Dad will file a gift tax return and apply $85,000 of his lifetime gift tax exemption to that transfer. This means that Dad will have $85,000 less in estate tax exemption available to his estate for transfers he makes at death.

In essence, one can define the term taxable gift as a "reportable gift." Not every taxable gift triggers the need to pay a gift tax, but every taxable gift must be reported in a federal gift tax return (Form 709). If the donor does not report all of the taxable gifts he made during his life, the duty to report those taxable gifts is imposed on the executor of his estate (which includes the successor trustee of his living trust, if applicable).

Another mistaken belief is that making a taxable gift during life "removes" the gifted amount from the donor's estate. That is not really true. When the donor dies, the taxable gifts he made during life are added back to his "tax base" at death. Assuming the IRS does not challenge the value of those taxable gifts, the pre-death gifts are included in the tax base at their value when the gifts were made. So how does making taxable gifts save estate taxes? Primarily, donors who make taxable gifts are removing from their estate (i) the future (post-gift) growth (appreciation) in the value of that asset and (ii) the future (post-gift) income earned by that asset. The benefit of making taxable gifts can be increased by using various techniques that discount the value of the gifted assets for federal gift tax purposes. In future newsletters, we will discuss some of these techniques.

Clawback. In a prior newsletter published before the election results, we discussed the "problem" that will occur for certain donors when the current $10 million basic exclusion amount drops to $5 million on January 1, 2026 (ignore inflation adjustments in this section). Because taxable gifts made during life are added to the donor's tax base at death, what if a donor made *taxable gifts* totaling $10 million before 2021 (which were fully covered by his lifetime gift tax exemption when made) and then dies in 2026 (when the exemption amount is only $5 million)? Will that donor's estate owe estate taxes on the difference? Normally, the answer would be "Yes" because the $10 million in taxable gifts made during life would be part of the donor's tax base at death and the exemption at the time of the donor's death would be only $5 million. However, per regulations released in November 2018 (the "anti-clawback regulations"), the answer is "No." The "excess exemption amount" (sometimes referred to as the "bonus exemption") will not be "clawed back" into the donor's estate at death. Thus, in our example, the donor has avoided "forever" transfer tax on $5 million (the difference between the $10 million given away before death and the $5 million exemption at death). Another way to say it is the donor was able to transfer the *bonus exemption* free of estate and gift taxes.

Based on the wording in the "anti-clawback" regulations, those rules should also apply if the Democrats drop the estate tax exemption to $3.5 million (or some other amount below the current exemption amount). For purposes of analysis, let's assume the new exemption amount passed into law is $3.5 million. A donor who did not make taxable gifts prior to 2021 (or who does not make taxable gifts prior to the effective date of the new legislation) that have a total value, in the aggregate, of *more than* $3.5 million, will not enjoy elimination of transfer taxes on the "excess amount" as in the example explained in the paragraph above because there is no "excess amount" or "bonus exemption" in that case. Those taxable gifts will be added to the donor's "tax base" at death, as is the usual case. In order to experience true tax avoidance "forever," the donor would have to transfer *more than* $3.5 million before the effective date of the new law (i.e., the new law setting the exemption amount at $3.5 million–note this assumes the estate tax exemption and the gift tax exemption are set at the same amount). If the new law reducing the exemption amount is made retroactive to January 1, 2021, then it's already "too late" to achieve the type of "forever tax avoidance" discussed in the first paragraph of this section.

String Statutes. Before we move on from estate and gift taxes, be aware that several "string statutes" are included in the Internal Revenue Code that cause assets that the donor gave away during life to be brought back into the donor's estate at death. The basic theory of the string statutes is that, even though the donor has given assets away, the donor has retained either (or both) "too much power" (or, the "wrong kind of power") over the assets that were given away *or* the right to income (or other enjoyment) from the gifted assets. When assets are brought back into the donor's estate at death, they are valued at their fair market value as of the donor's date of death, rather than at their gift tax value at the time when the gift was made. Thus, the post-gift appreciation in value of those assets does not escape estate tax (as is the case of a taxable gift that is only included in the tax base at death at its gift tax value). So gifts that are intended to be "fully completed gifts" must be carefully structured to avoid application of the string statutes.

<u>GST Tax</u>. We will keep our explanation of the GST tax very simple. There are basically three types of "generation-skipping transfers" that can trigger application of the GST tax:

1. Direct Skips.
2. Taxable Terminations.
3. Taxable Distributions.

Each person who transfers assets (the "transferor"), whether during life or at death, has an exemption from the GST tax ("GST exemption") that can be allocated to generation-skipping transfers he makes to avoid the GST tax. This is important because, when the GST tax applies, it is even worse than the estate tax. In the early days of the GST tax, many transferors failed to file the necessary tax return (Form 709) to allocate GST exemption to GST transfers they made. Fortunately, certain "deemed allocation rules" were added to the law to help avoid triggering GST taxes with respect to certain types of GST transfers. Many transferors are able to rely on those deemed allocation rules in many cases.

In essence, generation-skipping transfers involve transfers that benefit "skip persons." In the family context, a person two or more generations below the transferor is a skip person. Thus, a grandchild of the grandparent is a "skip person" (unless the grandchild's parent who was the child of the grandparent is deceased). Great-grandchildren are skip persons, too. Other rules apply to unrelated persons. An unrelated person more than 37½ years younger than the transferor is a "skip person."

A simple example of a *direct skip* is a gift from a grandparent to a grandchild, whether made during life or at death.

A simple example of a *taxable termination* is: grandparent creates a trust for child that lasts for child's lifetime and, when child dies, the trust assets are distributed to child's children (i.e., grandchildren of the transferor), in a way that avoids estate taxes in the child's estate.

A simple example of a *taxable distribution* is: grandparent creates a trust for the current benefit of both children and grandchildren and the Trustee makes a distribution from the trust to a grandchild.

Since 2004, the GST exemption has been the same as the estate tax exemption (but that could be changed).

We are not going to discuss the GST tax in more detail in this newsletter. However, the basic reason Congress added the GST tax to the law in 1986 was to prevent wealthy persons from avoiding the estate tax in each successive generation by keeping assets in long-term trusts. Many transferors affirmatively use their GST exemption to do just that (by creating long-term trusts that avoid estate taxes in each generation and, due to allocation of GST exemption "up front," also avoid GST taxes).

Planning Issues in View of the Election Results. Assuming any reduction in the exemption amount is *not* made retroactive to January 1, 2021, what types of estate planning could be done *before* the drop in the exemption becomes effective that will avoid transfer taxes on at least part of the transferred amount "forever"? As a reminder, taxable gifts made during life having a total value, in the aggregate, *less than the new exemption amount* will not be in the "forever" category. They will simply be in the "usual" category of taxable gifts that are part of the tax base at death. That doesn't mean it's a bad idea to make taxable gifts having a value less than the new exemption amount. Taxable gifts of appreciating assets and/or assets that produce a lot of income are always smart from a transfer tax standpoint, especially if the gift tax value of the gifted assets is able to be reduced as well.

The first thing to consider is whether you (or you and your spouse) are in a position to make taxable gifts that use your entire exemption amount? As noted earlier, the current exemption amount is $11.7 million. Many people who were able to give away their entire exemption amount already did that in 2020 (although those people have an additional $120,000 in exemption in 2021 due to inflation adjustments because the 2020 exemption amount was $11.58 million). Yet there may still be people who did not take such action before now who are able to do that in 2021. The main difference between gifting the full exemption amount in 2020 and gifting it now is that now we have the possibility of the drop in the exemption amount being made retroactive to January 1, 2021.

"Un-doing" Taxable Gifts. Because we do not know whether there will be a drop in the exemption amount this year that is retroactive to January 1, 2021, are there techniques that can be implemented in 2021 and then "un-done" if the new law makes those techniques less desirable than originally hoped?

One possibility for "un-doing" a transfer made in 2021 is a "disclaimer." A *disclaimer* is a refusal to accept a gift that, if done in accordance with federal tax regulations (so that the disclaimer is a "qualified disclaimer"), results in no adverse tax consequences for the person making the disclaimer (the "disclaimant"). Of course, the relevant gift documentation would need to provide, specifically, who can make a disclaimer and what happens in the event of a disclaimer. Perhaps the trust instrument would provide that, in the event of a disclaimer by the disclaimant, the disclaimed assets would either revert to the donor or, if the donor is married, pass to the donor's spouse or to a trust for the benefit of the donor's spouse.

One problem with the disclaimer approach is that a "qualified disclaimer" must be made within nine (9) months of the effective date of the transfer. If the transfer is made early in 2021, any tax legislation during 2021 might not be passed until after the nine (9) month disclaimer period has expired. Some commentators believe that, if there is tax legislation in 2021, it will not happen until the third quarter. So transfers could be delayed until a date in April 2021, making the nine month disclaimer deadline the same day of the month in January 2022.

Some commentators also worry about the "appearance" of a disclaimer provision in a trust instrument that provides that the disclaimed assets will revert to the donor. Was the donor's transfer to the trust ever really a completed gift in that case? It should be treated as a completed gift as long as there is no "pre-arranged plan" that the disclaimant will disclaim the gift if the new, reduced exemption amount is made retroactive to January 1. Of course, that is exactly the reason why the disclaimant would disclaim! But the donor absolutely cannot have an agreement with the disclaimant to do that.

Disclaimers are highly technical, especially disclaimers by a Trustee. Mistakes can easily be made with disclaimers, so great caution must be exercised in making disclaimers. However, it is something that some people are considering because of the possibility of Congress reducing the transfer tax exemption amount this year and making that change retroactive to January 1, 2021.

Other Taxable Gifts. There may be people who are willing to make a "permanent" transfer of significant assets if there is a way for them to receive benefits– in some cases, indirectly–from the assets given away. Two techniques in this category (but not the only ones) are (i) a Spousal Lifetime Access Trust (SLAT) and (ii) a charitable remainder trust (CRT). Neither of these techniques "solves" the retroactive problem discussed above, but both are consistent with the idea of giving something away during life but still "receiving benefits" from the gifted assets.

SLATs. A SLAT is a technique that is popular during times when the future exemption amount will–or could –be less than the current exemption amount (we created a lot of SLATs in 2012 when there was a risk that the $5 million exemption would drop to $1 million the next year).

Suppose Husband and Wife have $22 million in community property after-tax investment assets. Note that we are excluding the couple's home, tangible personal property and pre-tax retirement plans. Suppose also that Husband is still working and has a high-paying job. Husband and Wife could partition their $22 million in after-tax investment assets so that $11 million is Husband's separate property and $11 million is Wife's separate property. Husband could then create a SLAT for the benefit of Wife (and the couple's children and grandchildren) and put Husband's $11 million separate property investment assets into the SLAT. Husband would not be Trustee of the SLAT. Usually, Wife would be Trustee, although Wife could be Co-Trustee with an "independent Trustee" (an independent Trustee can be given broader distribution powers than an individual Trustee related to the donor).

The SLAT is for the primary benefit of Wife for her life. The SLAT usually permits distributions to be made to the couple's children and grandchildren while Wife is living as well. Distributions are made to Wife, children and grandchildren for their health, support, maintenance and education. On Wife's death, the SLAT will terminate and the assets will be distributed to separate Descendant's Trusts for the couple's children (and their children). The SLAT is a whole lot like a Bypass Trust that we frequently create when the first spouse dies. In this case, however, the SLAT becomes effective while both spouses are still living.

Husband's transfer to the SLAT is a completed gift that will use up $11 million (nearly all) of Husband's exemption. When Husband dies, the SLAT assets should not be not included in Husband's estate, no matter what those assets are worth at that time (because Husband did not retain any control over or interest in the SLAT). Because Wife can receive distributions from the SLAT during her life, Husband is indirectly benefitting from the SLAT assets. In our example, Husband is still working and earning significant annual income. Husband also still owns significant retirement plans. Therefore, Husband feels secure even though he has given away $11 million in assets.

Suppose, by the time Wife dies, the $11 million in the SLAT has grown to $20 million. Because of the structure of the SLAT, that $20 million in assets will not be taxable in Wife's estate for federal estate tax purposes.

It is possible, of course, that Husband and Wife could get divorced. In that case, Husband will own fewer assets than Wife because Husband put his $11 million in separate property investment assets into the SLAT. Husband may want the trust instrument that created the SLAT to provide that Wife's interest in the SLAT will terminate on divorce and the SLAT assets will be distributed to the children's trusts at that time.

Sometimes both spouses create SLATs for each other. If the "reciprocal trust doctrine" is avoided, that works.

<u>CRT</u>. If a client has "charitable intent" (an intent to provide benefits to charity), the client can create and fund (put assets into) a charitable remainder trust (CRT) and reserve what amounts to an annuity for his life (or, if married, his life and his spouse's life). We will not explain the details of the different types of CRTs in this newsletter, but the essence of a CRT is that the benefits of the gifted assets are split between one or more individuals and charity, with charity receiving what remains in the CRT when the CRT terminates. One of the primary advantages of creating and funding a CRT is that the client can put low basis, highly appreciated assets into the CRT and the CRT, which is a tax-exempt trust, can then sell those assets without the client (or the CRT) recognizing immediate capital gains on the sale of those assets. Thus, 100% of the sales proceeds (less selling costs) is held in the CRT, against which the retained annuity percentage payable to the client is calculated. In contrast, if the client were to sell those highly appreciated assets, first, and put the net sales proceeds into the CRT, the client would recognize capital gain on that sale and a lesser amount (the sales proceeds minus the capital gains taxes) would be placed in the CRT (producing a lower annuity for the client). The assets held in a properly administered CRT are not subject to estate taxes when the client dies, even though the client gave away those assets during life and retained an interest in them until his death.

One Democratic proposal may change one of the most favorable aspects of CRTs. The Democrats may dramatically increase the capital gains tax rate on gains over a certain amount, such as $1 million. This change may be effective on a future date, and not retroactive. When a CRT distributes the annuity to the donor over the donor's life, that distribution carries out the various types of income of the CRT, in a prescribed order, and, eventually, the capital gain on the sale of the CRT assets will be distributed to the donor. If the future capital gains tax rate is much higher than the current capital gains tax rate, then one of the benefits of a CRT under current law may not be realized.

<u>Descendant's Trusts</u>. Single people who have "excess wealth" not needed for their own support could set up Descendant's Trusts for their children (and grandchildren) *now* and transfer their exemption amount to those trusts *now*. Married couples can do this as well. The topic of our October 2018 newsletter was *Descendant's Trusts for Children and Grandchildren*, so we will not repeat that entire newsletter here (it is available on the firm's website). Most of our clients use Descendant's Trusts as "receptacles" for amounts given to children and grandchildren, whether those amounts are given during life or upon death. Children and grandchildren are among "the natural objects of a person's bounty," so it is consistent with that presumed intent for the donor (or married donors) to start making gifts to Descendant's Trusts for children and grandchildren during life (i.e., not wait until they die). This technique makes sense, especially, as a method for removing future growth in value and income earned by the gifted assets from the donor's estate. It also provides benefits to children and grandchildren *now*, rather than when the donor dies. In most cases, the Descendant's Trusts will start out as "grantor trusts" for federal income tax purposes. That makes the donor(s) taxable on the income earned by the Descendant's Trust assets. Payment of those income taxes by the donor(s) is not treated as a gift but it has the effect of a gift to the Descendant's Trusts and their beneficiaries. In addition, payment of the trusts' income taxes helps to reduce the size of the donor's estate. Further, "transactions" between the donor and the trusts are not recognized as taxable due to the trusts being grantor trusts for federal income tax purposes. This enables "freeze techniques" to be employed.

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Karen S. Gerstner & Associates, P.C. **January 31, 2021**

Summary. We do not know what the changes to the tax laws will be and when those changes will become effective. However, we would be glad to discuss the pros and cons of various estate planning techniques and the impact of possible tax law changes.

Estate Planning In Times of Uncertainty. There is no doubt that uncertainty inhibits estate planning. However, certain types of estate planning techniques are worth implementing even during times of uncertainty. What you do not want to do is wait until you are "suffering from your final illness" to do significant estate planning. Death bed planning is very high risk and does not achieve the same degree of benefits as planning implemented well before death. In addition, people who are suffering from a terminal illness or other serious condition may no longer have sufficient mental capacity to understand what they are doing and/or the physical strength to implement their estate plan. So do not let "the tyranny of the perfect" prevent you from taking steps that, perhaps, will not be perfect, but will still be a good choice for you and your loved ones.

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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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