WHAT THE COOL KIDS ARE DOING IN ESTATE PLANNING

Substantive Written Materials to Accompany Presentation

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These materials are intended to supplement the What the Cool Kids Are Doing in Estate Planning presentation. Some continuing education accreditation bodies assume conference attendees actually read, retain, and refer to formal written materials and thus require them as a condition to granting continuing education credit. Though this assumption is questionable on more than one level, it is easier just to give them what they want. So here you go.

To start, a planner needs to understand the current tax, economic, and political climate in order to determine what strategies are especially useful (or dreadful) right now. Let's start with that background.

I. INFLATION-ADJUSTED FEDERAL INCOME TAX BRACKETS FOR 2022 (Adapted from Rev. Proc. 2021-45)

<table>
<tr><th colspan="2">Taxable Income Exceeding</th><th rowspan="2">Ordinary Income</th><th rowspan="2">Adjusted Net Cap Gain* & Qualified Dividends</th><th rowspan="2">Medicare Surtax on Earned Income**</th><th rowspan="2">Medicare Surtax on Net Investment Income</th></tr>
<tr><th>Single</th><th>Married Filing Jointly</th></tr>
<tr><td>$0</td><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">2.9%</td><td rowspan="5">0%</td></tr>
<tr><td>$10,275</td><td>$20,550</td><td rowspan="2">12%</td></tr>
<tr><td>$41,675</td><td>$83,350</td><td rowspan="6">15%</td></tr>
<tr><td>$41,775</td><td>$83,550</td><td>22%</td></tr>
<tr><td>$89,075</td><td>$178,150</td><td>24%</td></tr>
<tr><td>$170,050</td><td>AGI over $250,000</td><td rowspan="2">32%</td><td></td><td></td></tr>
<tr><td>AGI over $200,000</td><td>$340,100</td><td rowspan="4">3.8%</td><td rowspan="4">3.8%</td></tr>
<tr><td>$215,900</td><td>$431,900</td><td rowspan="2">35%</td></tr>
<tr><td>$459,750</td><td>$517,200</td><td rowspan="2">20%</td></tr>
<tr><td>$539,900</td><td>$647,850</td><td>37%</td></tr>
</table>

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).
** Includes employer contribution of 1.45% (§3111(b)(6)), individual contribution of 1.45% (§3101(b)(1)), and additional tax of 0.9% for adjusted gross income over $200,000 for an unmarried individual and $250,000 on a joint return (§3101(b)(2), for years after 2012).

FEDERAL INCOME TAX RATES FOR TRUSTS AND ESTATES FOR 2022
(Adapted from Rev. Proc. 2021-45)

<table>
<tr><th>Taxable Income Exceeding</th><th>Ordinary Income</th><th>Adjusted Net Cap Gain* & Qualified Dividends</th><th>Medicare Surtax on Net Investment Income</th></tr>
<tr><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">0%</td></tr>
<tr><td>$2,750</td><td rowspan="2">24%</td></tr>
<tr><td>$2,800</td><td rowspan="3">15%</td></tr>
<tr><td>$9,850</td><td>35%</td></tr>
<tr><td>$13,450</td><td rowspan="2">37%</td></tr>
<tr><td>$13,700</td><td>20%</td><td>3.8%</td></tr>
</table>

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).

II. FEDERAL WEALTH TRANSFER TAX ADJUSTMENTS

A. GIFT TAX ANNUAL EXCLUSION

The Taxpayer Relief Act of 1997 provided for an inflation adjustment to the $10,000 federal gift tax annual exclusion under §2503(b), but only in increments of $1,000.

Date of gift	Annual exclusion
1997 – 2001	$10,000
2002 – 2005	$11,000
2006 – 2008	$12,000
2009 – 2012	$13,000
2013 – 2017	$14,000
2018 – 2021	$15,000
2022	$16,000

B. CHANGES TO THE §7520 RATE

Planners use the §7520 rate to discount the value of annuities, life estates, and remainders to present value. It is equal to 120% of the applicable federal mid-term rate under §1274(d), but rounded to the nearest two-tenths of a percent. It changes every month. In most cases, the §7520 rate for the month in which the gift or death occurs is used to calculated the gift or estate tax value of the annuity, life estate, or remainder interest being valued. In the case of a charitable lead or remainder interest, however, one can use the rate for the month in which the gift or death occurs or the rate for either of the two preceding months. The §7520 rate for a

calendar month is announced by the IRS via a Revenue Ruling typically released around the 18th of the preceding month.

Month	§7520 Rate
January 2022	1.6%
February 2022	1.6%
March 2022	2.0%
April 2022	2.2%
May 2022	3.0%
June 2022	3.6%
July 2022	3.6%
August 2022	3.8%
September 2022	3.6%

C. BASIC EXCLUSION AMOUNT

The 2017 Tax Cuts and Jobs Act doubled the basic exclusion amount under §2010(c)(3) from $5 million to $10 million, with adjustments for inflation after 2011 using a “chained-CPI” method. The 2017 Act provides that the basic exclusion amount will revert to $5 million (adjusted for post-2011 inflation under the previous “CPI” method) after 2025.

For decedents dying in	The basic exclusion amount is
2011	$ 5,000,000
2012	$ 5,120,000
2013	$ 5,250,000
2014	$ 5,340,000
2015	$ 5,430,000
2016	$ 5,450,000
2017	$ 5,490,000
2018	$11,180,000
2019	$11,400,000
2020	$11,580,000
2021	$11,700,000
2022	$12,060,000

D. REVENUE PROPOSALS FOR 2022

Although the House passed the Build Back Better Act in the fall of 2021, the Senate took no action on the bill. By early March, 2022, President Biden conceded defeat. Nonetheless, the Administration unveiled several interesting proposals in its annual “Green Book.” Many of these proposals are summarized below. The chances of any of them passing in the near future are remote, equivalent to the proverbial snowball suffering a fiery afterlife. But they give planners a glimpse into the policy priorities of the Administration. And if this agenda cannot be achieved in

Congress, perhaps it can be implemented through the Executive Branch (read: Treasury and the IRS).

Fiscal Year 2023 Revenue Proposals (The "Green Book") (March 28, 2022)

- Increase **C corporation** tax rate to **28%**
- Increase top marginal **individual** tax rate to **39.6%**, applicable to taxable income over $400,000 ($450,000 for couples)
- Eliminate preferential rates on **long-term capital gains and dividends** where taxable income exceeds $1,000,000
- Realize capital gains at **gift** or **death**
- New **minimum income tax** of 20% on "total income" for taxpayers with over $100 million in wealth
- Remainder in a **GRAT** must be worth at least **25%** of the value of the trust assets
- Transfers to **defective grantor trusts** are taxable
- Foundation distribution to a **donor advised fund** is not qualifying unless the DAF expends that amount by the end of the next year

III. THOUGHTS ON LEVERAGED WEALTH TRANSFERS

Given no one is expecting an imminent reduction in the basic exclusion amount, leveraged wealth transfers continue to be successful strategies. Two techniques in particular are well-suited to the current climate.

A. INSTALLMENT SALES TO DEFECTIVE TRUSTS

One of the most popular estate planning techniques involves the sale of property to a "defective grantor trust." The transaction not only minimizes transfer tax exposure but also allows the grantor to minimize income tax exposure by escaping (or at least deferring) gain on the appreciation in assets contributed to the trust.

Installment sale transactions offer significant planning benefits even when not paired with grantor trusts. The principal benefit is the chance to freeze the estate tax value of assets sold, thereby removing future appreciation from the seller's gross estate. The post-sale appreciation escapes both gift and estate taxes. In addition, the amount of income tax paid by the seller is removed from the seller's gross estate. The installment sale can also enhance the seller's liquidity to the extent the seller disposes of an illiquid asset (like closely-held stock or real estate) in exchange for cash.

Traditional installment sale transactions also pose two significant drawbacks. First, the seller has to pay income tax on the resulting gain from the sale. Second, the seller loses all control over the transferred interests. If the buyers are inexperienced in management, this may pose a significant problem to the seller. This problem can be avoided if the seller sells only nonvoting stock or limited partnership interests and maintains an active role in the business by assisting the buyer in management of his or her affairs.

Use of the defective grantor trust can avoid both of these drawbacks. The grantor's installment sale of assets to a grantor trust is ignored for federal income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184. Because the federal income tax laws see the grantor and the grantor trust as the same person, an installment sale between these parties is essentially a sale from the grantor to the grantor, a non-event. Thus, installment payments from the trust to the grantor, whether representing principal, interest, or both, will not be taxable to any extent.

The sale of property to a trust is not a gift because the trust is paying adequate and full consideration in the form of a promissory note. So long as the note bears the applicable Federal rate of interest, there are no federal gift tax consequences on the sale. Note that this rate will almost always be lower than the §7520 interest rate required for GRATs and other popular wealth-shifting techniques.

Some practitioners are concerned that the Service would scrutinize an installment sale transaction as not being at arms-length (thus posing potential gift tax consequences), since a reasonable seller might be disinclined to sell a substantial amount of assets to a buyer that likely holds no other equity. Since securing a personal guarantee from the trustee or from the beneficiaries may be unrealistic, these practitioners believe the defective grantor trust should be pre-funded with cash or other assets in an amount equal to about ten percent of the value of the property to be transferred by sale. Some commentators have observed a lemming approach—since so many practitioners advise their clients to make seed gifts to the defective grantor trust, making a seed gift may be the safest course of action. Others rationalize a seed gift by observing that an installment note from an undercapitalized buyer is sufficiently risky that the fair market value of the note would be less than its principal balance. And the exchange of property for an installment note worth less than the property's value (because of the risk discount) would be a gift to some extent that could trigger liability for gift tax.

Assuming the planner designed a suitable defective grantor trust, estate tax exposure for the grantor is minimized. If the grantor dies before the note has been repaid, the value of the note will be included in the grantor's gross estate. Notice this limits the possible gross estate inclusion to the fair market value of the transferred property as of the sale date; all future appreciation in value on the transferred assets passes to the trust beneficiaries free of transfer taxes.

No portion of the trust property is included in the grantor's gross estate under §2036(a) since the property was sold (not gifted) to the trust. This is true even if the grantor dies before the

note has been repaid; all appreciation in the value of the transferred property will escape estate taxation.

B. CHARITABLE LEAD TRUSTS

Planners are very familiar with charitable remainder trusts, where the grantor typically transfers property in trust, retains the right to receive either a fixed dollar amount or a fixed percentage of the trust's fair market value at least annually, and grants the remainder the one or more charitable organizations. The gift to the charity is eligible for the gift tax charitable deduction. But the gift tax deduction is also allowed for a gift to charity of a current interest in a trust that is in the form of a guaranteed annuity or unitrust interest. A trust that provides for such current payments to charity is usually called a "charitable lead trust" (CLT). A gift of a guaranteed annuity or unitrust interest is deductible for income tax purposes only if the income of the CLT will be taxed to the donor under the grantor trust rules. §170(f)(2)(B). If the income is not taxed to the donor, any accumulated income including capital gains will be taxed to the trust. The IRS has ruled that a CLT may provide that income in excess of the amount needed to make the required payments to charity may be accumulated for distribution to noncharities upon termination of the trust. Rev. Rul. 88-82, 1988-2 C.B. 336. No charitable deduction is available if the trust provides for current distribution of excess income to noncharitable beneficiaries. Contributions to a typical CLT qualify for the gift tax charitable deduction; the grantor is not taxed on the income of the trust and, under §642(c), the trust may deduct distributions of income to the charitable beneficiaries. LR 20021020.

The IRS has issued sample trust forms for both inter vivos charitable lead annuity trusts (CLATs), Rev. Proc. 2007-45, 2007-2 C.B. 89, and testamentary CLATs, Rev. Proc. 2007-46, 2007-2 C.B. 102. The guidance for inter vivos CLATs contains two forms. One form creates an inter vivos CLAT designed to last for a term of years and to be treated as a separate taxpayer. The other form creates an inter vivos CLAT for a term of years intended to function as a grantor trust. The forms contain alternate provisions for basing annuities on the life of an individual, leaving apportionment of the annuity amount in the trustee's discretion, phrasing the annuity in the form of a specific dollar amount, naming alternate charitable beneficiaries, and, in the case of the grantor trust, restricting the charitable beneficiary to a public charity. The sample testamentary CLAT instrument in Rev. Proc. 2007-46 contains a lead interest for a term of years, together with alternate provisions for basing annuities on the life of an individual, leaving apportionment of the annuity amount in the trustee's discretion, phrasing the annuity in the form of a specific dollar amount, and naming alternate charitable beneficiaries. For an analysis of the forms, see Fox, A Guide to the IRS Sample Lead Trust Forms-Part 1, 36 Est. Plan. 7 (Apr. 2009), and Fox, A Guide to the IRS Sample Lead Trust Forms-Part 2, 36 Est. Plan. 13 (May 2009). The IRS has also issued sample trust forms for inter vivos charitable lead unitrusts (CLUTs), Rev. Proc. 2008-45, 2008-2 C.B. 224, and testamentary CLUTs, Rev. Proc. 2008-46, 2008-2 C.B. 238. There are two sample forms for inter vivos CLUTs, one that structures the CLUT as a separate taxable entity and another that causes the CLUT to qualify as a grantor trust. Both forms create the lead interest for a term of years followed by distributions to one or more individuals that are United States citizens or residents. The form for a testamentary CLUT likewise uses a term

of years for the charitable lead interest. All of these forms include a number of annotations and alternative provisions that can be used to customize the form to a client's specific situation. Subject to the other limitations imposed by §170, including the 30 percent limit for gifts "for the use of" a qualified charity, Reg. §1.170A-8(a)(2), a donor is entitled to a present income tax deduction for the full value of a guaranteed annuity or unitrust interest given during the year to a qualified charity if the donor is treated as the owner of the trust for income tax purposes. A gift of a guaranteed annuity or unitrust amount also qualifies for a gift tax deduction, LR 8338108, and a bequest of an income interest similarly qualifies for an estate tax deduction.

A CLT may also be an attractive method for transferring appreciating property to private beneficiaries. The contribution to a trust can be structured to provide a charitable deduction for part or all of the assets contributed. The gift tax on the transfer to beneficiaries is based on the total asset value less the charitable contribution. Later, the appreciated remainder is distributed to designated beneficiaries free from the gift or estate tax.

A CLT may appeal to a client whose future income will be in lower tax brackets, since the gift accelerates the deduction for the future payments to the charity, while the income to fund those payments is taxed later when received. The rules prevent a donor from taking a large deduction at the outset and avoiding taxation on the trust income in later years by relinquishing the interests or controls that caused the donor to be treated as its owner under the grantor trust rules: If the donor ceases being treated as owner of the trust, he or she must recapture part of the deduction as current income. The amount recaptured is the excess of the deduction received for the gift, over the discounted value of the income that was taxed to the donor under the grantor trust rules. §170(f)(2)(B). The amount must be included in the donor's final income tax return if the donor ceases to be treated as owner of the trust by reason of death. Reg. §1.170A-6(c)(5), Example 3.

A CLT is not tax-exempt. Accordingly, the trust instrument may direct that distributions to charity consist of ordinary income to the extent available, otherwise from capital gain (distributions of which would qualify for the §642(c) charitable deduction). See Rev. Rul. 83-75, 1983-1 C.B. 114; LRs 8026032; 8030054.

For income tax purposes a CLT is entitled to deduct the amount of the annuity payable to the charitable beneficiary. §642(c). However, under §642(c)(1), no deduction is allowable for amounts payable to the charitable beneficiary in excess of the amount of the annuity unless made "pursuant to the terms of the instrument." In Rebecca K. Crown Income Charitable Fund, 98 T.C. 327 (1992), no deduction was allowed under §642(c) or 661 for amounts paid to the charitable beneficiary in excess of the annuity amount where the trust instrument under certain circumstances allowed additional amounts to be paid "in commutation of future amounts payable hereunder" and no such commutation was made. In the course of the opinion the Tax Court emphasized, "however, that we express no opinion here as to whether the payment of a charitable lead annuity may be accelerated consistent with the requirement of section 2522(c)(2)(B) that the charitable interest be in the form of a guaranteed annuity." 98 T.C. at 336.

The IRS has ruled that no charitable deduction is allowable with respect to a CLT that gives the trustee the power to commute and prepay the charitable beneficiary the value of the future annuity payments which it is entitled to receive. Rev. Rul. 88-27, 1988-1 C.B. 331. The ruling reached that conclusion based on the provisions of Reg. §25.2522(c)-3(c)(2)(vi)(a), which define a "guaranteed annuity" as requiring the payment of a determinable amount for a specified term. The right of the trustee to commute and prepay the annuity deprives the charitable beneficiary of the right to receive payments of a fixed amount over a specified term. Accordingly, the trust failed to qualify for a charitable deduction.

Interestingly, a private letter ruling concluded that the termination of a CLT pursuant to a court decision which authorized commuting and prepaying the charitable beneficiary would not violate any of the private foundation rules. LR 8808031. The ruling did not consider whether or not the commutation and prepayment would jeopardize the charitable deductions that were allowed to the grantor 11 years before.

The rules regarding the determination of the GSTT inclusion ratio for CLATs prevent the ratio from being determined at the time the trust was created, which would have given the transferor the benefit of considerable leverage. See §2642(e). Specifically, for transfers taking place after October 13, 1987, the GSTT inclusion ratio of a CLAT requires use of the "adjusted GSTT exemption" and the value of the property of the trust "immediately after the termination of the charitable lead annuity." Under §2642(e) the adjusted GSTT exemption (the amount of the transferor's GSTT exemption that was allocated to the trust adjusted by the interest rate that was applied to determine the amount of the charitable deduction purposes of §2055 (estate tax) or §2522 (gift tax)) is the numerator and the value of all of the property in the trust immediately after termination of the charitable lead annuity is the denominator.

C. ISSUES TO CONSIDER IN LEAVERAGED WEALTH TRANSFERS

A client considering a large lifetime wealth transfer in trust should think through whether to include disclaimer language in the gifting instrument and whether to structure the trust to include a trust protector or some other fiduciary with a power to give the grantor a last-minute general power of appointment.

But most importantly, the client should make sure to give *value* and not *property*. When making inter-vivos gifts, some taxpayers want to make full use of the federal gift tax annual exclusion and/or the applicable exclusion amount. When the gifted property is difficult to value—like fractional interests in real estate, works of art, or interests in closely-held businesses—there is a risk that a gift intended not to trigger gift tax liability might do so if the Service successfully asserts that the value of the gifted property is higher than the value claimed by the taxpayer. But in *Wandry v. Commissioner*, T.C. Memo. 2012-88, the Tax Court approved the use of a gifting formula that made reference to the *value* of the gifted property rather than the property itself. In that case, the taxpayers gave interests in a limited liability company to their children and grandchildren according to a formula that read as follows:

I hereby assign and transfer as gifts, effective as of January 1, 2004, a sufficient number of my Units [in the LLC] so that the fair market value of such Units for federal gift tax purposes shall be as follows:

Name	Gift Amount
Kenneth D. Wandry	$261,000
Cynthia A. Wandry	261,000
Jason K. Wandry	261,000
Jared S. Wandry	261,000
Grandchild A	11,000
Grandchild B	11,000
Grandchild C	11,000
Grandchild D	11,000
Grandchild E	11,000
	1,099,000

Although the number of Units gifted is fixed on the date of the gift, that number is based on the fair market value of the gifted Units, which cannot be known on the date of the gift but must be determined after such date based on all relevant information as of that date. Furthermore, the value determined is subject to challenge by the Internal Revenue Service ("IRS"). I intend to have a good-faith determination of such value made by an independent third-party professional experienced in such matters and appropriately qualified to make such a determination. Nevertheless, if, after the number of gifted Units is determined based on such valuation, the IRS challenges such valuation and a final determination of a different value is made by the IRS or a court of law, the number of gifted Units shall be adjusted accordingly so that the value of the number of Units gifted to each person equals the amount set forth above, in the same manner as a federal estate tax formula marital deduction amount would be adjusted for a valuation redetermination by the IRS and/or a court of law.

The Service argued that the language created an invalid savings clause, but the court upheld the language as a valid formula clause. Practitioners have relied on *Wandry* in utilizing similar formula gift clauses to minimize the risk of liability for gift tax based on a valuation adjustment.

This lesson was learned the hard way in *Nelson v. Commissioner*, T.C. Memo. 2020-81. In this case, the taxpayers, a married couple, created a limited partnership that owned a 27-percent in a closely-held equipment business and about $675,000 in investment assets. They were the 1-pecrent general partners and Mrs. Nelson owned a nearly 94-percent limited partner interest. The remaining interests were held by UTMA accounts and trusts established for their children. On December 31, 2008, Mrs. Nelson signed an assignment instrument stating that she:

* * * desires to make a gift and assign to *** [a trust for the benefit of herself and her daughters] her right, title, and interest in a limited partner interest

> having a fair market value of TWO MILLION NINETY-SIX THOUSAND AND NO/100THS DOLLARS ($2,096,000.00) as of December 31, 2008 * * *, as determined by a qualified appraiser within ninety (90) days of the effective date of this Assignment.

On January 2, 2009, she then sold "a limited partner interest having a fair market value of TWENTY MILLION AND NO/100THS DOLLARS ($20,000,000.00) as of January 2, 2009 * * *, as determined by a qualified appraiser within one hundred eighty (180) days of the effective date of this Assignment." A subsequent appraisal determined the value of a 1-percent limited partner interest was $341,000. If the formulas in the gift and sale documents worked, that meant Mrs. Nelson gifted a 6.14-percent limited partner interest and sold a 58.65-percent limited partner interest. The partnership then recorded transfers of percentage interests consistent with the appraisal.

On their 2008 federal gift tax returns, the taxpayers split Mrs. Nelson's gift, meaning each had gifted $1,048,000, an amount that utilized (but did not exceed) four annual exclusions and the applicable exclusion amount. In 2013, the Service determined that the value of each gift was $1,761,009, not $1,048,000. The Service also determined that the property transferred in the $20 million sale was really worth just over $33.6 million, meaning each taxpayer had made a 2009 gift of just over $6.8 million.

The taxpayers argued that the language in their assignment documents used valid formula clauses consistent with that approved in *Wandry*, but the Tax Court observed that the gifted and sold interests "are expressed in the transfer instruments as an interest having a fair market value of a specified amount as determined by an appraiser within a fixed period. The clauses hang on the determination by an appraiser within a fixed period; value is not qualified further, for example, as that determined for Federal estate tax purposes." So because the transfers were based on the value as determined by the appraisal and not on the finally determined gift tax value, the taxpayers were stuck with the percentage interests reflected on the gift tax return. The Tax Court then went on to address the value of the transferred interests, holding that the taxpayers made combined gifts of about $2.5 million in 2008 and about $4.1 million in 2009. From the perspective of the taxpayers, this was a better result than the Service's initial determination, but the result likely still stings.

If they had a mulligan, one suspects the taxpayers would omit the "as determined by a qualified appraisal…" clauses from the gift and sale instruments. Indeed, had there been transfers simply of interests with a fixed "fair market value" or a fixed "fair market value as finally determined for federal gift tax purposes," the results likely would have been different. In the end, then, this case signals that well-drafted formula gift clauses still work.

IV. OTHER STRATEGIES TO CONSIDER

A. PLANNING FOR THE $10,000 CAP ON THE DEDUCTION FOR STATE AND LOCAL TAXES

Prior law allowed a taxpayer to deduct state and local property tax as well as either state and local income or sales taxes (as well as foreign real property taxes) without limitation. For example, if a taxpayer in 2017 paid local real property tax of $5,000 in connection with the taxpayer's personal residence, state income tax of $10,000, and state sales tax of $13,000 on personal costs, the taxpayer can deduct a total of $18,000 (the $5,000 in real property tax and the sales tax of $13,000, since that amount is larger than the $10,000 of state income tax).

For 2018 through 2025, the 2017 Tax Cuts and Jobs Act limits the total deduction a taxpayer can claim for state and local taxes unrelated to the taxpayer's trade or business or other profit-seeking activity to $10,000, and the deduction for foreign real property taxes on property unrelated to a business or investment activity is repealed entirely. In the example above, then, if the same taxes were paid in 2018 the total deduction would be limited to $10,000. If, on the other hand, the real property taxes were paid in connection with investment property, the total deduction would be $15,000 ($10,000 in state income or sales tax plus the $5,000 in real property taxes since the real property taxes are incurred in connection with a profit-seeking activity).

The $10,000 limit on personal state and local taxes is reduced to $5,000 in the case of a married individual filing a separate return. It seems odd that the limit is the same for joint filers and unmarried individuals (whether filing as head of household or not), but the separate figure for married individuals filing separately clearly signals this is the case.

B. CHARITABLE REMAINDER TRUSTS FOR RETIREMENT PLANS

The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 represented the first major piece of federal legislation significantly affecting retirement plans in 13 years. The SECURE Act made several sweeping changes, including allowing individuals to use funds in §529 plans to repay student loans, offering greater opportunities for part-time employees to participate in plans, and making it easier for administrators of 401(k) plans to offer annuities. From an estate planning perspective, there are four significant changes.

First, the age for starting required minimum distributions has increased from 70-1/2 to 72. The change is applicable for those born after June 30, 1949 (a person born that day would have turned 70-1/2 on January 1, 2020).

Second, prior to the SECURE Act, an individual could not contribute to a traditional IRA starting in the calendar year in which the individual reached age 70-1/2. That age limit has been removed effective for 2020 and later.

Third, and most important, is the ten-year payout rule for most designated beneficiaries. In the "good old days" (2019 and earlier), there were two types of beneficiaries, "designated beneficiaries" and "non-designated beneficiaries." Generally, post-death distributions to designated beneficiaries could be "stretched out" over the designated beneficiary's lifetime. Where the designated beneficiary was the participant's adult child, for example, the deferral could be significant. But in the case of non-designated beneficiaries (generally, the participant's estate or a trust not qualifying as a "conduit" or "accumulation" trust), the distributions had to be paid over a five-year period, often resulting in federal income tax being paid at higher rates and over a shorter period.

Starting in 2020 and going forward, there are now three types of beneficiaries, each with their own rules. So-called "**eligible designated beneficiaries**" still qualify for taking distributions over their life expectancies. There are five types of eligible designated beneficiaries: (1) a participant's surviving spouse or a "conduit" trust for that spouse; (2) a participant's minor child or a "conduit" trust for that minor child (but only until the child reaches the age of majority); (3) a disabled beneficiary, a "conduit" trust for that disabled beneficiary, or an "accumulation" trust that meets certain rules; (4) a chronically ill beneficiary, a "conduit" trust for that chronically ill beneficiary, or an "accumulation" trust that meets certain rules; and (5) a beneficiary less than 10 years younger than the participant.

Benefits payable to individuals who are **designated beneficiaries** but not eligible designated beneficiaries (as well as any "conduit" trusts for such individuals) and all "accumulation" trusts must be paid within ten years of the participant's death. Specifically, all benefits must be paid by December 31 of the year that contains the tenth anniversary of the participant's death. Like the five-year payout rule, distributions do not have to be made at regular intervals; it is sufficient that all funds are withdrawn by the December 31 deadline. This is where the charitable remainder trust comes in handy.

For **non-designated beneficiaries** (still defined generally to include the participant's estate and a trust not qualifying as a "conduit" trust or "accumulation" trust), the five-year period to withdraw benefits continues to apply.

Finally, the SECURE Act provides that the 10-year payout applies upon the early death of a pre-SECURE Act designated beneficiary. Suppose an adult child of a participant who died before 2020 dies before the end of the child's life expectancy. Formerly, a successor beneficiary could "step into the shoes" of the child and continue to receive payments over the rest of what would have been the deceased child's life expectancy. Now, the 10-year payout rule applies to the successor beneficiary.

C. LONG-TERM GRATS

In a low interest rate environment, there is a good case for creating a GRAT with a very long term that the grantor almost certainly will not survive. Although there will be gross estate inclusion upon the death of the grantor, if the §7520 rate at death is significantly higher than

the §7520 rate in effect at the trust's creation, only a fraction of the value of the trust corpus will be subject to estate tax.

Ultra-Long-Term GRATs (aka "99-Year GRATs")

- Create traditional zeroed -out GRAT but with very long term
- If (when) the grantor dies, gross estate inclusion determined by the formula to the right →
- If the §7520 rate at death is higher than §7520 rate when GRAT formed, likely only a portion of the assets will be subject to estate tax at death

Annual amount
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§7520 rate at death

EXAMPLE: $10 million transfer to 60 -year GRAT created in September, 2022, when §7520 rate was 3.6%

- Annuity amount = $408,993
- If §7520 rate at death 20 years later is 6.0%, then gross estate inclusion = $6,816,550
- But if assets grow at 6%, trust will have $17,026,305
- So only 40% of trust assets included in gross estate!

D. SPOUSAL LIFETIME ACCESS TRUSTS

Should planners find themselves on the eve of a reduction in the basic exclusion amount, a common strategy is the so-called "spousal lifetime access trust," or "SLAT." In essence, a SLAT is an inter vivos credit shelter trust: one spouse creates an irrevocable trust for the benefit of the other spouse. The trust is structured such that gifts from the donor spouse to the trust do not qualify for the unlimited marital deduction for federal gift tax purposes, thus consuming at least a portion of the donor spouse's basic exclusion amount.

A SLAT is commonly structured as a grantor trust for federal income tax purposes so that lower federal income tax rates might apply. At the same time, however, the trust will be structured such that no portion of the trust estate will be included in the beneficiary's spouse gross estate for federal estate tax purposes. A SLAT that mirrors the provisions of a credit shelter trust will work for this purpose.

The SLAT will provide for successor beneficiaries upon the death of the beneficiary spouse. To incentivize those remainder beneficiaries to maintain cordial relations with the beneficiary spouse, the beneficiary spouse can be given a testamentary power to appoint the remainder among those beneficiaries.

While SLATs are seen as an effective strategy for utilizing an exclusion amount that will otherwise vanish, planners and clients need to be aware of some risks. First, the donor spouse

should understand that amounts transferred to the trust cannot be returned to the donor spouse. Sure, the beneficiary spouse may choose to share the benefits of distributions with the donor spouse, but there can be no prearranged commitment to that effect.

Second, some thought should be given to what will happen upon dissolution of the marriage before death. If the trust names the beneficiary by name, that person will continue to benefit from the trust after divorce. If that is not the donor spouse's intent, some planners suggest that the trust define the beneficiary not by name but instead by relationship ("my spouse").

Finally, if each spouse wants to create a SLAT for the benefit of the other, the trusts should contain substantially different provisions such that a court would be hard-pressed to apply the "reciprocal trust doctrine." If the doctrine applies, each grantor would be treated as the grantor of the trust for the grantor's benefit, thus forcing inclusion of the trust estate in the grantor's gross estate at death. But where two trusts have substantially different terms, there is a strong argument that the trusts are not truly "reciprocal" and, thus, the doctrine should not apply. The trusts might have different rights to income, different powers to invade corpus, or different powers of appointment, for example.

E. PLANNING PARADIGMS FOR MARRIED COUPLES

The current structure of the federal income, estate, and gift tax system makes it so no one template can be used for all married couples. Instead, modern tax planning requires married couples to be sorted into one of three "buckets," each with its own template.

BUCKET ONE	BUCKET TWO	BUCKET THREE
Combined net worth less than one basic exclusion amount (no more than $12.06 million in 2022)	Combined net worth more than one basic exclusion amount but not more than two basic exclusion amounts (more than $12.06 million but not more than $24.12 million in 2022)	Combined net worth more than two basic exclusion amounts (more than $24.12 million in 2022)

This section of the materials offers a possible template for each bucket. Before doing so, two points must be stressed from the outset. First, the application of state estate, gift, and inheritance tax laws may affect the relative size of each bucket and even, perhaps, the total number of buckets in play. Suppose, for example, that a married couple with a $7 million combined net worth resides in a state that imposes its own wealth transfer tax with an exclusion amount of only $2 million. The strategies discussed below for Bucket One assume no transfer tax at all will be imposed. If the amount of state estate tax is a concern, the planner in this example might limit the Bucket One template to couples with combined net wealth of $2 million or less and use some of the strategies from Bucket Two in an attempt to plan for the state estate tax. But even that approach requires caution, as state estate tax systems may not

permit all of the options described in Bucket Two, most notably QTIP and portability elections. So where state transfer taxes are an issue, the planner will need to give careful consideration as to how these templates may be applied successfully to couples that face liability for such taxes.

Second, just as no two snowflakes are alike, no two estate plans are ever identical. What follows are general templates that a planner can use as a starting point in designing the precise estate plan that will work best for any particular married couple. These templates do not consider the special issues that arise, for example, in planning for a beneficiary with special needs, planning for couples that hear the word “dynasty” and get all atwitter, or planning for couples that intend to leave the bulk of their wealth to one or more charitable organizations. Likely no one will use the exact templates set forth herein, but hopefully they provide a helpful framework for building plans that will actually be implemented.

1. Planning for Bucket One Couples. There is a three-part template for married couples with a combined net worth not in excess of the basic exclusion amount.

BUCKET ONE TEMPLATE
* Trust or outright gift upon death of first spouse?
* Ensure stepped-up basis for all assets on death of surviving spouse
* Consider protective portability election

Transfer Upon First Spouse’s Death: Trust or Outright Gift? The couple needs to decide how the assets of the first of them to die should pass. For most couples, there are two choices: by outright gift to the surviving spouse or to a trust of which the surviving spouse is a beneficiary. In answering this question, taxes are irrelevant. Clients choosing to use a trust will be doing so for non-tax reasons. Those reasons could include: (1) the desire of the first spouse to die to control the disposition of his or her assets after death; (2) a concern that the surviving spouse may not have the capacity or desire to manage the assets; and (3) a concern that assets in the name of the surviving spouse might be vulnerable to creditors.

Of course there are also good reasons for clients to prefer an outright gift, like the desire to avoid the costs of trust formation and administration or the desire to avoid the complexity of trusts (you can’t get much simpler than an outright gift). Happily, Bucket One couples are free to choose the method that works best for them; taxes do not control any of the decisions here.

Ensure All Assets Get Stepped-Up Basis on Survivor’s Death. Since transfer tax planning is not an issue for Bucket One couples, it is crucial that planners get the income tax planning piece right. And that means ensuring everything gets a fresh-start, fair market value basis for income tax purposes upon the surviving spouse’s death.

Where couples choose to let assets pass to the surviving spouse by **outright gift**, the step-up in basis on the surviving spouse’s death is assured since the spouse owns everything. At this point, however, it is worth mention that the fresh-start, fair market value basis on property passing from a decedent can cause a “step-down” in basis as well (as where the property’s value at the

time of the surviving spouse's death is less than the surviving spouse's adjusted basis in the property). While estate planners are well-trained in making sure such losses are recognized prior to death so they are not lost, clients will sometimes find a way to die before fully purging loss assets from their portfolios. "Step-downs" will thus happen from time to time. But most beneficiaries will benefit from the application of the fair-market-value-at-date-of-death rule.

Obtaining a stepped-up basis for everything on the surviving spouse's death is more complicated where the couple decides to have assets pass from the first spouse to die via a **trust**. If structured as a typical irrevocable trust, the assets of the trust will not receive a stepped-up basis on the death of the surviving spouse because those assets are not included in the surviving spouse's gross estate for estate tax purposes. For Bucket One couples using trusts, therefore, the key is to create a trust that causes inclusion of the trust assets in the survivor's gross estate. Gross estate inclusion is not an adverse result for Bucket One couples, recall, because federal wealth transfer taxes are not an issue: even if everything is included in the surviving spouse's gross estate, the total size of the estate is less than the surviving spouse's basic exclusion amount.

There are at least two ways to structure a trust so that it results in gross estate inclusion, thus assuring that the assets get a stepped-up basis on the surviving spouse's death. First, the trust instrument can give the surviving spouse a testamentary power to appoint all or any portion of the trust estate to the surviving spouse's estate. This is a **general power of appointment**, and property subject to a general power of appointment is generally includible in the gross estate of the power-holder. In order for this approach to get the maximum advantage, the surviving spouse should be entitled to all of the income from the trust (payable at least annually) for the surviving spouse's life. This makes the property passing to the trust eligible for the estate tax marital deduction, thus maximizing the amount that can pass to the surviving spouse through a portability election, as described below. But since estate taxes are not a factor for Bucket One clients, it is not critical that the surviving spouse receive the income. Nor is it crucial that the power be so broad; it is sufficient, for example, that the spouse has a testamentary power to appoint the trust property only to the creditors of the surviving spouse's estate.

Second, the trust can be structured to qualify for the qualified terminable interest property ("**QTIP**") exception to the terminable interest rule. If a trust meets the requirements for a QTIP election and the executor of the estate of the first spouse to die properly makes the QTIP election, the assets remaining in trust upon the death of the surviving spouse will be included in the surviving spouse's gross estate, thus assuring here too that the assets qualify for a stepped-up basis. Some practitioners had been concerned that the Service might disregard QTIP elections made by the estate of a Bucket One deceased spouse on the grounds that the QTIP election was not necessary to avoid imposition of federal estate tax. In Revenue Procedure 2016-49, however, the Service made clear that it would not disregard a valid QTIP election unless requested to do so by the executor.

Consider the Protective Portability Election. By definition, estate taxes are not an issue for Bucket One couples. Even if the clients completely bungle the handling of the first spouse's

estate, the surviving spouse alone has a basic exclusion amount ample enough to shelter all of the property from federal wealth transfer taxes. Thus one may rightfully wonder why the Bucket One template would consider the need for a portability election.

Planners might consider a portability election upon the death of the first spouse simply because the surviving spouse may come into other, unexpected wealth (prizes, jackpots, punitive damage awards, treasure trove) or may see unexpected surges in the value of assets. In any of those cases, having the deceased spouse's unused exclusion amount in addition to surviving spouse's own basic exclusion amount could prove helpful. Since the only cost to making the portability election is filing a timely estate tax return that would be subject to the relaxed reporting requirements described above, this would likely be cheap insurance.

2. Planning for Bucket Two Couples. Planning for these couples is perhaps the most challenging. Clearly *some* transfer tax planning is in order; if the planner does nothing and wastes the first spouse's applicable exclusion amount, the surviving spouse will not have sufficient exclusion to cover the couple's combined net worth, even if those assets do not appreciate in value after the death of the first spouse.

The question, though, is what kind of planning makes the most sense. Before 2011, we always used our friend, the credit shelter trust. Even where the credit shelter trust made no sense outside the world of taxes, it was often the only recourse to make sure each spouse's exclusion was utilized fully. Now, however, we also have the portability election at hand. And for clients in Bucket Two, the portability election is usually all we need to make sure federal wealth transfer taxes remain a nullity. So the planner has to consider which is better: using the good, old-fashioned credit shelter trust or the new-fangled portability election.

When Credit Shelter Trust is Better. In many cases, the credit shelter trust will be the better option. The two principal advantages of credit shelter trusts are these:

(a) Asset Appreciation Expected. Unlike the basic exclusion amount, the "deceased spousal unused exclusion amount" from a portability election does not adjust for inflation. Thus, for example, suppose the executor of the first deceased spouse elects to have a $11 million DSUE Amount pass to the surviving spouse. When the surviving spouse dies 25 years later, the basic exclusion amount may be substantially higher, but the DSUE Amount will still be $11 million.

On the other hand, assets placed in a credit shelter trust will not be subject to estate tax on the death of the surviving spouse no matter how much they may appreciate in value. If the assets owned by the surviving spouse are expected to appreciate substantially before the surviving spouse's death, then, the credit shelter trust will usually be the preferred option.

(b) Client Wants to Use the Generation-Skipping Transfer Tax Exemption. While the portability election applies for both federal estate tax and federal gift tax purposes, it does not apply for purposes of the generation-skipping transfer tax. On the other

hand, executors can elect to apply the GSTT exemption to assets placed in a credit shelter trust, permanently shielding the trust assets from the generation-skipping transfer tax. If the couple wants to make significant provision for grandchildren and other beneficiaries further down the line of descent, the credit shelter trust will be more attractive.

When Portability is Better. But there are situations where portability may have the edge over credit shelter trusts. Here are three that come to mind:

(a) Some Assets Don't Fit Well in Credit Shelter Trusts. Retirement accounts and residences make for poor assets in a credit shelter trust. For income tax purposes we can generally achieve better results by naming the surviving spouse as beneficiary instead of a trust. For purposes of excluding gain from the sale of a residence, moreover, title in the surviving spouse's name is better since trusts cannot occupy a residence, one of the conditions required for excluding gain.

(b) Some Surviving Spouses Don't Survive Long Enough. If the surviving spouse does not live for a meaningful period of time following the first spouse's death, there is little chance that assets inside of a credit shelter trust will have had an opportunity to appreciate in value to any significant extent. So after undergoing the expense, delay, and complexity involved in funding and administering the credit shelter trust, it would do no better than the simple, cost-effective portability election.

(c) Stepped-Up Basis May be More Important. Remember that assets owned either outright by the surviving spouse or by a QTIP trust will get a stepped-up basis for income tax purposes on the death of the surviving spouse. Assets inside of the typical credit shelter trust, however, do not get a step-up in basis. One must therefore check the balance sheets, for if the lurking capital gain in the estate is substantial yet the combined net worth puts the couple just over one basic exclusion amount, the step-up in basis matters much more than the estate tax savings—to the point that a credit shelter trust may be unwise.

BUCKET TWO TEMPLATE
* Trust or outright gift upon death of first spouse?
* If <u>outright gift</u> preferred, use disclaimer planning
* If <u>trust</u> is preferred, use *Clayton* QTIP

So the decision between a credit shelter trust and a portability election, ultimately, comes down to the answers to these five questions: (1) when will the first spouse die?; (2) what assets will the couple have at the time of the first spouse's death?; (3) how much longer will the surviving spouse live after the death of the first spouse?; (4) what will the basic exclusion amount be when the first spouse dies?; and (5) what will the transfer tax rates be upon the death of the first spouse? If we know this information, we can make the right choice. But few planners will be in a position to answer these questions with any confidence. Accordingly, the important theme for all planning in Bucket Two is **flexibility**. We want a plan that can let the couple choose the right path (credit shelter trust or portability election) when they have better

answers to those five questions (i.e., after the death of the first spouse) instead of a plan that forces them to commit to one path now when there is so much uncertainty. This template does that.

Transfer Upon First Spouse's Death: Trust or Outright Gift? It all starts with the same question posed to Bucket One couples: if taxes were not an issue, what should happen to the assets when the first spouse dies? Since we can create an effective plan regardless of which option the couple chooses (outright gift or trust), tax consequences have no relevance at this stage. See the Bucket One template for discussion of when couples might prefer outright gifts over trusts and vice versa.

Outright Gifts – Disclaimer Planning. If the couple elects to have the assets of the first spouse pass to the survivor by outright gift, then the testamentary document (will or living trust) should contain a provision whereby any gift properly **disclaimed** by the surviving spouse shall pass to a credit shelter trust. This way, we keep both portability and the credit shelter trust on the table, and we need not choose between them until after the death of the first spouse to die.

If, for example, we know after the death of the first spouse that portability is the better option (because the survivor is not expected to live long, or because of the nature of the assets, or because of whatever other reason), the surviving spouse simply accepts the gift. The executor can then file an estate tax return that claims a full marital deduction. This reduces the taxable estate to zero (since all passes to the surviving spouse outright), and then the unused applicable exclusion amount passes to the surviving spouse. But if we decide that a credit shelter trust is the better option, the spouse can disclaim the gift (or disclaim an amount equal to the amount of the first spouse's remaining applicable exclusion amount) and by operation of the instrument the gift will pass to the credit shelter trust.

This structure postpones making the ultimate decision until after the death of the first spouse. Like any plan making use of qualified disclaimers, the planner should discuss with the couple the practical constraints involved. For instance, the surviving spouse must not accept the benefit of any of the deceased spouse's property in order for any disclaimer to be valid. That means funds will need to be available for the surviving spouse so that the survivor is not tempted to accept the benefit of the deceased spouse's property before the final decision whether to make a disclaimer has been made.

Trusts – Clayton *QTIP.* If the couple instead opts to have the assets of the first spouse pass to the survivor through a trust, a good vehicle is the so-called *Clayton* QTIP trust. A *Clayton* QTIP is just like a regular QTIP trust in that all income is to be paid at least annually to the surviving spouse and trust distributions during the spouse's lifetime can be made only to the surviving spouse. And like a regular QTIP trust, the executor has to elect to treat assets intended to qualify for the marital deduction as "qualified terminable interest property." But the *Clayton* QTIP trust contains an additional provision: to the extent the executor does not

elect to qualify an asset passing to the trust as qualified terminable interest property, such property shall automatically pass to a credit shelter trust.

An example illustrates the flexibility of this approach. Suppose the deceased spouse's will leaves everything to a *Clayton* QTIP. If the deceased spouse's executor decides that portability is the preferred planning option for whatever reason, the executor will make the QTIP election on a timely filed estate tax return for all of the assets in the trust. The gift will qualify for the unlimited marital deduction, meaning the deceased spouse's taxable estate will be reduced to zero and the full deceased spousal unused exclusion amount can port over to the surviving spouse. If the executor instead decides that the credit shelter trust is best, the executor can select assets with a value equal to the deceased spouse's remaining applicable exclusion amount and then make the QTIP election for *all other assets*. The unelected assets will pass automatically to the credit shelter trust.

As with the disclaimer approach, the *Clayton* QTIP allows the couple to defer making the decision between portability and the credit shelter trust until after the first spouse dies. It thus provides the needed flexibility.

3. Planning for Bucket Three Couples. Unlike good stories, we have saved the most boring for last. Not much has changed when it comes to advising, say, the $50 million estate. The techniques used prior to both the Act and the American Taxpayer Relief Act remain attractive now. Choosing between portability and a credit shelter trust alone will not be enough.

The planner still needs to consider strategies that can reduce the amount of wealth subject to tax while still retaining the desired level of control over and cash flow from the assets in the estate. These strategies include: spousal lifetime access trusts (SLATs); irrevocable life insurance trusts (ILITs); grantor retained annuity trusts (GRATs); charitable lead trusts (CLATs and CLUTs); charitable remainder trusts (CRATs, CRUTs, NIMCRUTs); donor-advised funds, private foundations, and pooled income funds; family limited partnerships (FLPs) and limited liability companies; installment sales to "defective" grantor trusts; and dynasty trusts. Of course, even some Bucket Two couples may find one or more of the these strategies useful in their own planning as well. But it's now primarily Bucket Three couples that are concerned with gross estate minimization.