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Trust Planning in a High Exemption Environment

Presented by: Nolan T. James Jr., Esq.

Roadmap

- Recent History of Federal Estate Taxes
- Taking Advantage of the Large Tax Exemption – **BIG PICTURE**
- Estate Planning Techniques Clients Should Consider in this Environment
  - Effectively Utilizing Gift Tax Exemption
  - Grantor Retained Annuity Trusts (“GRATs”)
    - GRATS and Cryptocurrency
  - Installment Sale to an Intentionally Defective Grantor Trust
  - Intra-Family Loans
  - Charitable Lead Annuity Trust (“CLAT”)
  - Spousal Limited Access Trust (“SLAT”)
  - Domestic Asset Protection Trust (“DAPT”)
- Overview of President Biden’s Estate, Gift and Generation-Skipping Transfer Tax Plan
- Comment on Business Succession Planning

Recent History of Federal Estate Taxes

Prior to 2002 – "Unified" Transfer Tax Credit for all taxpayers *IRC §§2010, 2505*

Economic Growth and Taxpayer Relief Reconciliation Act of 2001 ("EGTRRA")– *"De-Unified" the Estate and Gift Tax Credit [Effective 2004 – 2009]*

Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 – *Reunified the Estate, Gift and GST Tax Exemptions, increasing them to $5 mm for 2011, with an inflation adjustment for 2012.*

American Taxpayer Relief Act of 2012 (ATRA) – *Made changes to the Gift, Estate and GST Exemptions from the TRA of 2010 "Permanent", while increasing the effective rate on the excess from 35% to 40%.*

Tax Cuts and Jobs Act of 2017 – *For 2021, the IRS raised the Estate Tax Exemption to $11.7 million per individual or 23.4 million per couple. A provision of the TCJA more than doubled the exemption and raises it each year to keep pace with inflation.*

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Taking Advantage of the Large Tax Exemption – BIG PICTURE

1. Get the Money
2. Get ALL the Money
3. Get ALL the Money **Now!**

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Estate Planning Techniques Clients Should Consider in this Environment

A Strategy for Businessowners

Transfer Appreciating Assets

- Gifting shares in a business owned by a client will allow the appreciation to take place outside of the client's estate
- Utilize the current lifetime Gift Exemption of $11.7 million today, because it almost certainly won't be here for long.
- Excellent strategy for clients who own businesses that will substantially appreciate over time.

Transferring Appreciating Assets

Real World Example

An entrepreneur just started his business and transferred a 25% stake in his company into a trust for his two children, who were 10 and 8 at the time. A year later the business sold for more than $1 billion.

Transferring the $1 billion business to his trust cost the client $50,000 in exemption because the business wasn't worth anything at the time, but now $250 million is out of his estate.

Take away, <u>the earlier clients start this type of planning the better</u>.

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Transferring Appreciating Assets

MAINTAINING CONTROL DURING THE PROCESS

Clients need to balance the need for estate planning with what's good for their business.

Clients should consider organizing or even reorganizing their business so that they have both voting and non-voting shares. Clients will want to put the non-voting shares in a trust for their children or other family members so that they can in effect have their cake and eat it too.

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Estate Planning Techniques Clients Should Consider in this Environment

Grantor Retained Annuity Trusts
("GRATs")

What is a GRAT?

A Grantor Retained Annuity Trust is an estate planning technique which allows for the transfer of appreciation of assets at minimal or no gift tax cost.

How do GRATs work?

(1) The Grantor transfers assets into a trust for a term of years.
(2) During the term of the trust, the Grantor receives an annuity payment, at least annually, of either a fixed dollar amount or a fixed percentage of the fair market value of the property placed into the trust.
(3) At the end of the trust term, any remaining principal will be distributed to the trust beneficiaries.
(4) A gift to a GRAT will result in a taxable gift equal to the fair market value of the property being placed into the trust, less the present value of the annuity payments that the Grantor will receive from the GRAT.
(5) In most cases, a GRAT is structured to "Zero-out," with the present value of the retained annuity interest equaling the value of the property transferred into the GRAT – meaning the taxable gift is virtually zero!

GRATS AND CRYPTOCURRENCY

A GRAT may also be a useful vehicle for cryptocurrency because of volatile nature of the valuation of cryptocurrency.

Best Practices for Cryptocurrency Transactions:

(1) Conduct a qualified appraisal of the value of the cryptocurrency being transferred to the GRAT, this will form the basis of the annuity amount for the GRAT.

(2) The Trustee should open a simple bank account for the GRAT at the time of funding.

(3) Exchange the cash in the bank account for cryptocurrency in the GRAT , thus locking in the value of the cryptocurrency.

(4) The annuity payment will be made with cryptocurrency by the trustee sending it to the Grantor's cryptocurrency address.

(5) An actuary will determine the annuity amount in regular currency, the trustee will then determine how much cryptocurrency is necessary to satisfy the annuity payment.

(6) Remember: Cryptocurrency is still classified as property for tax purposes, therefore the value of cryptocurrency for the purpose of establishing a basis in the GRAT will be the price at which the cryptocurrency would change hands between a willing buyer and a willing seller on the date of the transfer. *See* Treas. Reg. 25.2512-1 (2019).

Estate Planning Techniques Clients Should Consider in this Environment

INSTALLMENT SALE TO AN INTENTIONALLY DEFECTIVE GRANTOR TRUST
(“IDGT”)

What is an IDGT?

An Intentionally Defective Grantor Trust is an estate planning technique which is used to freeze certain assets of an individual for estate tax purposes, but not for income tax purposes. The intentionally defective trust is created as a grantor trust with a loophole that allows the grantor to continue paying income taxes on certain trust assets, as income tax laws will not recognize that those assets have been transferred away from the individual.

How does an Installment Sale to an IDGT work?

(1) A sale of property is made to a trust in return for an installment note that bears interest at the Applicable Federal Rate (“AFR”)

(2) An amount equal to at least 10% -15% of the value of the property should be placed in the trust as “seed” money, this will avoid a potential argument from the IRS that the note is not a true debt and that the loan proceeds should result in a taxable gift. The “seed money” is treated as a taxable gift”.

(3) The note may provide for installment payments over a period of time or may provide for annual interest-only payments with a balloon payment of principal at the end of the term, using the AFR as the hurdle rate.

(4) At the end of the trust term, any income and appreciation on the trust assets that exceeds the payments required to satisfy the note will pass to the trust beneficiaries free of gift, estate, and possibly GST tax.

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Estate Planning Techniques Clients Should Consider in this Environment

INTRA-FAMILY LOANS

What is an Intra-Family Loan?

An Intra-family loan is a simple and effective estate planning and wealth transfer strategy which allows parents to provide a financial resource to their family members for a specific use or create a trust for their benefit. The rates used for intra-family loans are typically more attractive than what may be commercially available.

How does an Intra-Family Loan work?

(1) The Lender loans funds to the Borrower (Borrower can be an individual or a trust), documented by a promissory note.

(2) So long as the loan bears interest no lower than the hurdle rate (which is the AFR for this strategy), the transaction is not considered a gift.

(3) Intra-Family loans work great in the low-interest-rate environment we are in.

(4) Existing notes evidencing Intra-Family loans bearing higher interest rates may be refinanced to take advantage of the lower current interest rates, but only if sufficient consideration is provided by the borrower to the lender usually in the form of a material pay down of the outstanding principal balance of the existing note.

Estate Planning Techniques Clients Should Consider in this Environment

Charitable Lead Annuity Trust

What is a Charitable Lead Annuity Trust ("CLAT")?

An estate planning and wealth transfer strategy which is designed to provide financial support to one or more charities for a period of time, with the remaining assets eventually going to family members or other beneficiaries. This form of irrevocable trust is designed to reduce a beneficiary's potential tax liability upon inheritance.

How does a Charitable Lead Annuity Trust Work?

(1) A CLAT provides for the payment of a fixed dollar amount to one or more charitable beneficiaries for a specified period of time, at least annually, regardless of the income generated by the CLAT.

(2) The trust may be established for a term of up to 20 years or can be based on the life or lives of individuals living at the time of the creation of the trust.

(3) The amount of the charitable contribution deduction at the creation of the CLAT will be the present value of the annuity using the Section 7520 Rate.

(4) A CLAT will result in a taxable gift upon creation equal to the fair market value of the assets gifted to the trust reduced by the present value of the annuity.

(5) A CLAT works better in a low interest rate environment because a lower Section 7520 Rate will cause the present value of the annuity paid to the charitable beneficiaries to be higher, which in turn produces a larger charitable contribution deduction and a smaller taxable gift to the remainder beneficiaries.

(6) In a low interest rate environment, there is a greater chance that the rate of return will exceed the Section 7520 Rate, which increases the value of the assets passing to the noncharitable remainder beneficiaries free of gift or estate tax at the end of the annuity term.

Estate Planning Techniques Clients Should Consider in this Environment

SPOUSAL LIMITED ACCESS TRUST ("SLAT")

What is a Spousal Limited Access Trust ("SLAT")?

An estate planning and wealth transfer strategy which involves a spouse establishing an irrevocable trust for the other spouse along with other beneficiaries (generally children and/or grandchildren) during his or her lifetime, meaning the donor spouse does not need to pass away for this trust to be created and for funds contained within to be utilized.

How does a Spousal Limited Access Trust work?

(1) The trust names an independent trustee who has discretion to make distributions of trust assets to the trust's beneficiaries, including the Beneficiary Spouse.

(2) The Donor Spouse's transfer to the trust does not qualify for the marital deduction because the Beneficiary Spouse has only a discretionary interest in the trust. Accordingly, the Donor Spouse's exemption amount is utilized, and the post-transfer appreciation on the trust's assets will not be subject to future gift estate, and possibly GST tax.

(3) If the spouses later need income and/ or principal from the trust, and the independent trustee agrees, the trustee will make a distribution of trust income and/or principal to the Beneficiary Spouse. Because distributing assets to the Beneficiary Spouse reduces the gift, estate, and GST tax benefits associated with the SLAT and should be done only when absolutely necessary.

Estate Planning Techniques Clients Should Consider in this Environment

DOMESTIC ASSET PROTECTION TRUST ("DAPT")

Domestic Asset Protection Trust ("DAPT")?

An estate planning and wealth transfer strategy which involves a spouse establishing a "self-settled" irrevocable trust which allows the settlor to be a beneficiary along with others, such as children and/ or grandchildren, as determined in the discretion of an independent trustee.

How does a Domestic Asset Protection Trust work?

(1) Creates a solution for an individual who wants to utilize the high exemption amounts without eliminating any possibility from benefitting from the gifted assets in the future.

(2) There are only 17 states that have statutes governing DAPTs, (Ohio is one), so the assets must be situated in a DAPT state or a local trustee must be named.

(3) The statute governing this trust will not permit the settlor's creditors to reach the assets of this trust even if he or she is a discretionary beneficiary of the trust.

Overview of President Biden's Estate, Gift and GST Tax Plan

1. Decrease the Federal Estate Tax Exemption amount
   - $5 Million per individual ($10 Million for a married couple)
   - $3.5 Million per individual ($7 Million for married couples)

2. Increase top tax rate to 45%

   (some reports have this proposed top tax rate as high as 55%)

3. Repeal stepped-up basis on death
   - Mark-to-market approach or Simply eliminate the step-up without imposing a mark-to-market tax on death.

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Concern about Repealing Stepped-Up Basis on Death

Elimination of the step-up rules could capture billions in taxes from the rich, but it could hurt some people who do not have enormous amounts of wealth.

Example: A married couple purchases their home 40 years ago for $100K. They pass away and the home is worth $400K as of the date of death of the surviving spouse's death. Under the current rules, their heirs would only be responsible for taxes on any gains above the $400k date of death value. However, if the step up were eliminated, those heirs would be responsible for the gains on anything above $100k

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Concern about Repealing Stepped-Up Basis on Death

Estate Plan Workaround

If the step-up is eliminated, clients may consider gifting the house earlier in order to get the house into their heir's name so that additional appreciation would occur in the heir's name and not in the parent's name.

This is not ideal because most people wish to retain ownership of their homes for a variety of reasons.

Rumor Mill

(Unofficial additional tax policy considerations)

1. Valuations of promissory notes used in Intra-Family Loans

2. Increase funding for IRS enforcement, auditing more gift and estate tax returns.

3. Limiting the use of valuation discounts reducing the value of assets held by closely-held family businesses due to lack of marketability.

4. Broadening the application of the Federal Estate Tax.

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Enactment Considerations

1. Democrats control both Chambers of Congress (including tax-writing committees).

2. 60 votes are required in the Senate to avoid a filibuster.

3. “Budget Reconciliation” process will allow certain types of legislation to move forward in the Senate with a simple majority vote.

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Wealth Transfer Planning and Retroactivity Considerations

1. There is a possibility that any changes to the estate, gift and GST tax exemptions may become retroactive to January 1, 2021.

2. If clients have not already done some planning, there are some additional considerations that should be made in light of retroactivity considerations:

   (a). Disclaimer Planning

   (b). QTIP Elections

   (c). Formula Transfer Clauses

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Wealth Transfer Planning and Retroactivity Considerations

Disclaimer Planning

A trust drafted with retroactivity considerations should contain provisions which allow one designated beneficiary ("DB") of a trust to disclaim on behalf of all trust beneficiaries.

This will provide the DB with nine (9) additional months to disclaim the gift and, if the DB does so, the result should be that the gifted assets are returned to the donor without using any of the donor's gift and / or GST exemption. Thus avoiding a large amount of gift tax.

Wealth Transfer Planning and Retroactivity Considerations

QTIP Elections

A married person could make a gift to a trust for the benefit of a US citizen spouse that would qualify for the marital deducition if a QTIP election is made or, if no election is made, would instead pass to a non-qualifying trust for the spouse that would use up the donor spouse's lifetime exemption.

QTIP elections provide the donor spouse with flexibility either to make the QTIP election or not in the following calendar year when the related gift tax return is due depending on whether any reduction of the gift and or GST exemption amount is made retroactive to January 1, 2021.

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Wealth Transfer Planning and Retroactivity Considerations

Formula Transfer Clause

Here, the donor would make a gift of a fractional interest of an asset where the numerator is the donor's available exemption on the date of the gift and the denominator is the fair market value of the gifted assets, as finally determined for federal gift tax purposes. If the exemption amount on the date of the gift is retroactively reduced, the formula should "self-correct" so that the donor only gives away an amount equal to the donor's available exemption on that date.

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Final Thoughts on Tax Policy Considerations and Wealth Transfer Planning

1. Anything is possible, but we should not make knee jerk reactions in estate planning.
2. Taxes are likely to go up.
3. No one can predict the future, thus once change is enacted, it will be important to promptly and thoroughly review estate plans with clients to make certain that the plans still function as intended.

BUSINESS SUCCSSION PLANNING

For clients who own businesses, the business makes up the lion's share of their estate. Therefore, succession planning needs to be at the center of any estate plan.

Many small business owners don't know what their business is worth.

72% of small businesses do not have a succession plan and according to surveys conducted by Wilmington Trust, 8 out of 10 entrepreneurs admit to being too preoccupied with their business to develop a succession plan.

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Questions

Nolan T. James, Jr., Esq.
Attorney at Law
Cavitch, Familo & Durkin
E-mail: njames@Cavitch.com
Office: (216) 621-7860
Mobile: (440) 320-9422

* Licensed to practice in Ohio and Florida

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