USE IT OR LOSE IT?

Now could be the time to use some or all
of your $11.58 million gift tax exemption.

Presented by: Tom McGuire, David Brown and Nancy Hearne
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Why make gifts before year end?

- The federal gift and estate tax exemption is at an all time high-

  $11.58 million for a single person

  $23.16 million for a married couple.

- A Democratic sweep in November might happen - If the Democrats gain control of both the White House and Congress, they plan to reduce the exemption to $5 million or less.

- The massive federal bailout also increases the likelihood of higher income, dividend and capital gains taxes.

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Other Possible Changes

- Raising gift and estate tax rates;
- Eliminating the “step-up” in basis;
- Taxing unrealized capital gains on the owner’s death;
- Restricting the use of Grantor Retained Annuity Trusts (GRATs);
- Eliminating valuation discounts in intra-family transfers of property, and
- Eliminating the use of grantor trusts to achieve wealth transfers free of gift and estate taxes.

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Current Rules

Total Assets:	$25,000,000
Less: exemption	
For married couple	
(11,580,000 x 2)	($23,160,000)
Assets subject to tax:	$1,849,000
	x .40
Federal Estate tax:	$736,000

* Assumes a married couple is residing in a no death tax state

Possible Post-Election Rules #1

Total Assets:	$25,000,000
Less: exemption	
For married couple:	($11,580,000)
Assets subject to tax:	$13,420,000
	x .40
Federal Estate tax:	$5,368,000

Possible Post-Election Rules #2

Total Assets:	$25,000,000
Less: exemption	
For married couple:	($11,580,000)
Assets subject to tax:	$13,420,000
	x .55
Federal Estate tax:	$7,381,000

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Retroactive Legislation

- Acting now would allow transactions to potentially avoid the effect of legislation passed in 2021 that is made retroactive to January 1, 2021.

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Do you want to make a gift?

- In 2012 some clients gave away significant wealth to avoid an anticipated lower estate tax exemption. But that didn't happen.

- Some of them have had regrets.

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Should you make a gift?

- How much can you give away?
- How much do you want to give away?
- Which assets should you give away?

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Spousal Lifetime Access Trusts (SLATs)

- Use exemption now but retain indirect access to the assets
- Spouses could create trusts for each other
- Works better in some situations…

- …than it does in others

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Spousal Lifetime Access Trusts (SLATs)

Client Example

Step 1: Hannah decides:

- that she wants to use a portion of her gift tax exemption; and
- that she loves Jake; and
- that she **trusts** Jake

Step 2: Hannah creates a trust for Jake's primary benefit:

- Distributions can be made to Jake
- Jake can control trust disposition if circumstances change before his death

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Spousal Lifetime Access Trusts (SLATs)

The results so far:

1. Used Hannah's exemption
2. Trust assets are available to Jake (and, indirectly to Hannah)
3. The trust assets are protected from Hannah's creditors and Jake's creditors
4. The trust assets are not in Hannah's taxable estate
5. The trust assets are not in Jake's taxable estate

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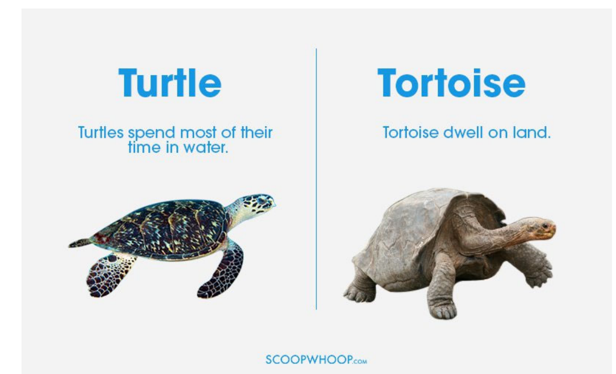
Spousal Lifetime Access Trusts (SLATs)

- Step 3: Jake wants to use exemption too!

He could create a **<u>similar</u>** trust for Hannah and thereby take advantage of both exemptions without losing access to the assets

The trusts should be similar, but different. Could feature different:

- Trustees
- Distributions
- Appointment Powers
- **TIMING**



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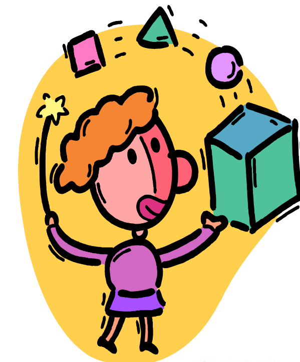
Strategy: Sale to "Defective" Trust

- **Assume**: Gary Grantor owns a business, Sky High Botanicals, with a true value of $15mm. Gary anticipates significant future growth due to the high demand for "botanicals" during COVID pandemic.
  - Due to lack of marketability of Sky High, a non-public company, Gary's appraiser is able to justify a 30% valuation discount. The value for tax purposes = $11.5mm
- **Creation of Trust**: Gary creates a "defective" trust for his children and initially funds the trust with $500k of cash or securities.
  - This is a taxable gift which uses a small portion of Gary's lifetime gift tax exemption.
- **Sale of Sky High**: Gary sells Sky High to trust for
- $11.5mm
  - NOT a taxable event, because trust is "defective"
  - Gary's estate is effectively "frozen" at $11.5mm



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Strategy: Sale to "Defective" Trust

- **<u>Sale (continued):</u>** Trust gives Note to Gary
  - Interest only with a balloon in 9 years. Mid-term IRS rate for October of 2020 is only 0.38%.
  - Interest is paid to Gary and is <u>not</u> taxable income to Gary due to nature of trust.
  - Debt service is funded by Sky High cash flow OR simply from the assets initially gifted to the trust by Gary.

- **<u>Trust Continues to Grow:</u>** For the next 9 years, Sky High makes profits distributions to the trust and Sky High stock rises in value.
  - The profits distributions accumulate in the trust but Gary pays the income tax on the taxable income, allowing for tax-free growth of the trust.
  - If Sky High is sold, Gary likewise would pay income tax on any capital gain, allowing additional accumulations for Gary's children.
  - Gary's payment of income tax on income generated in the trust is not considered an additional taxable gift,

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Strategy: Sale to "Defective" Trust

- **Note Becomes Due:** After 9 years, Note from trust becomes due to Gary.
  - Accumulated income and funds in the trust can be used to pay down the Note.
  - If necessary, a portion of Sky High can be transferred back to Gary in satisfaction of the Note, again with no gift or income tax consequence. If Sky High is now worth $25 mm, only that portion equivalent to the Note balance ($11.5 mm) would need to be transferred back to Gary. The remaining value is effectively trapped in the trust and passes to the children transfer tax-free.

- **Gary's Death:** Let's say Gary dies 15 years after the trust is created when the value of the trust is now $30 mm. Assuming Gary received back the $11.5 mm upon payment of the Note, effectively $18.5 mm would have passed estate and gift tax free to Gary's children, for a savings of $7.4 mm!

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Strategy: Sale to "Defective" Trust

- **Additional Planning Options:**

- *If Republicans prevail*
  - Gary could swap the Note into the trust and take back assets worth $11.5 million. If Sky High has increased significantly in value, the appreciation above the initial value is trapped in the trust. The asset swap is NOT a taxable event, because the trust is "defective".
  - The trust now owns the Note under which it is now both debtor and creditor. The debt is extinguished yet significant value remains in the trust due to appreciation in value of Sky High plus intervening profits distributions.
- *If Democrats prevail*
  - Before the gift tax exemption decreases, Gary makes a gift to the trust by forgiving the entire Note. The gift uses $11.5 of Gary's gift tax exemption, but the appreciation and income earned in the trust from the date of the original transfer passes transfer tax free to Gary's children.

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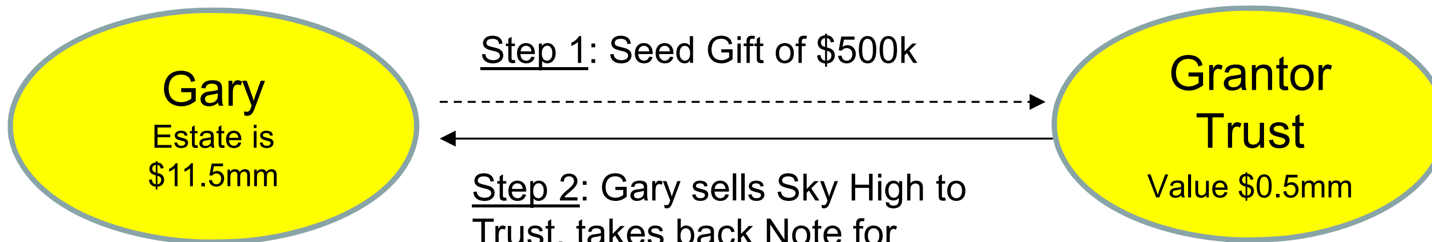
Sale to "Defective" Trust Illustration

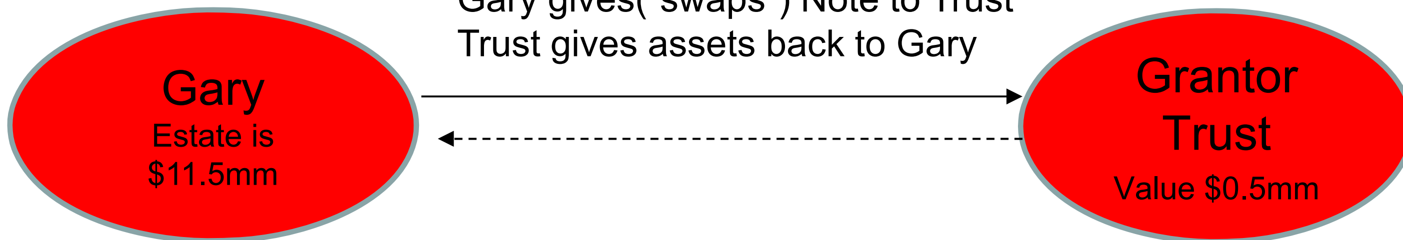
Step 1: Seed Gift of $500k



Step 2: Gary sells Sky High to Trust, takes back Note for $11.5mm

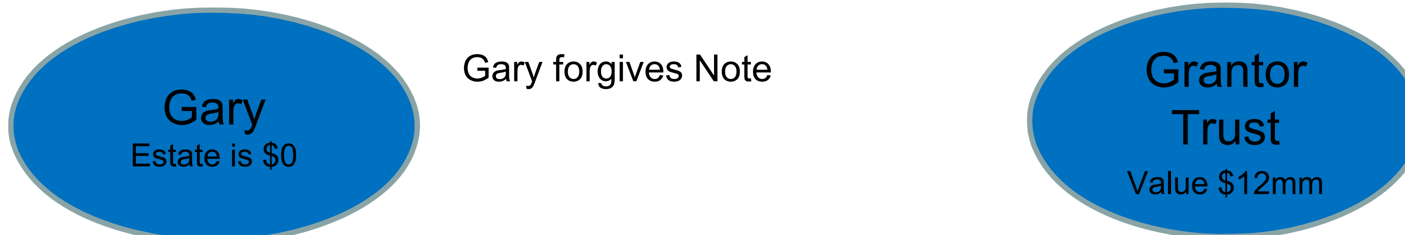
Step 3: If Republicans control: Reverse Step 2

Gary gives("swaps") Note to Trust
Trust gives assets back to Gary



Step 3: If Democrats control: Make a taxable gift, reduce estate

Gary forgives Note



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Grantor Retained Annuity Trust (GRAT)

- A GRAT allows you to freeze the present value of stock (or other assets) you put into the GRAT and shift the potential upside growth to your beneficiaries (your kids) with little or no gift or estate tax.

- The GRAT assets are returned to you in the form of annuity payments. The appreciation, if any, at the end of the term passes to your kids tax-free. A win win if you don't need the appreciation.

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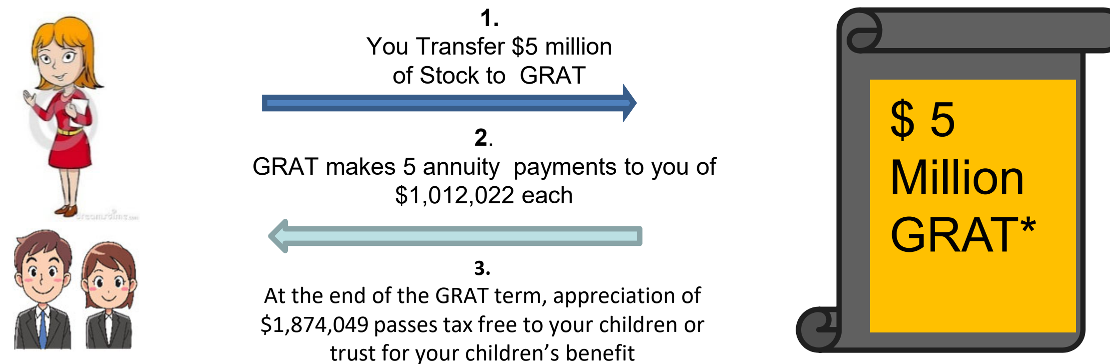
Here's How a GRAT Works:

- Suppose, in October, 2020, you put $5 million of stocks into a GRAT, with a five year term. The idea is to empty out the GRAT by paying you an annuity which is equal to the value of the assets you put into the GRAT. Utilizing the very low current 7520 rate, the stocks are expected to grow at .4% annually.
- But let's assume the GRAT's portfolio actually grows at 10% annually.



* Assumes a 7520 rate of .4%, a 5 year term and annual appreciation of 10%.

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Why Fund a Longer Term GRAT?

- If you think the stock market will be depressed during a Democratic control of the White House and Congress, consider a longer term GRAT.
- If the GRAT portfolio was to increase at 10% a year and the GRAT term is 10 years, your kids would receive $4,823,660 in 2030!

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Our Presenters

Nancy Hearne is a partner and member of Saul Ewing Arnstein & Lehr's Personal Wealth, Estates and Trusts Practice Group and works in our Princeton and Philadelphia offices. She focuses on estate and tax planning, estate and guardianship disputes and the creation and continuing representation of both public and private charitable organizations. Nancy assists families with a broad range of tax and personal wealth planning issues and works with them to create plans which are often multi-generational and innovative. She has extensive experience and devotes significant time to working with families in establishing and operating private foundations.

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David Brown is counsel and member of Saul Ewing Arnstein & Lehr's Personal Wealth, Estates and Trusts Practice Group. He helps family businesses and high-net worth individuals navigate legal issues connected to the preservation and transfer of their wealth to subsequent generations or other interested parties. He focuses in particular on estate planning, charitable planning, and trust and estate administration. Drawing on his LL.M. in Taxation, David also advises clients on tax issues that arise in the planning and ongoing administration processes, as well as on legal issues involving asset protection planning strategies.

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