PLANNING FOR CLIENTS
WHO MIGHT HAVE A TAXABLE ESTATE

By

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I. INTRODUCTION

A. In General

As advisors, if we knew when clients were to pass away, who was to survive them, the assets included in their taxable estates, and what the tax laws would be at the time of their deaths, we could all design perfect estate plans. We could also advise clients, with absolute accuracy, when and how to make lifetime gifts to minimize taxes and best effectuate their non-tax objectives. Of course, we cannot know any of these things, so we must simply do the best we can with what we have. In many cases, doing so requires building flexibility into the client's estate plan in anticipation of potential changes to the tax laws or a client's family or financial circumstances.

B. Overview of Materials

This paper discusses how to design and implement "core" estate plans that become effective upon a client's death, such as Wills and revocable trusts, in light of fluctuations to the transfer tax exemption amounts. This paper also explores how to design and implement gifting strategies for clients who might have a taxable estate. Above all, this paper is designed to leave the reader with practical examples of how to add value to client relationships by providing creative and proactive solutions.

The remaining portions of this paper are organized as follows:

- Part II establishes a framework by discussing the new planning environment that has emerged as a result of substantial increases to the transfer tax exemption amounts.
- Part III explains how advisors can generally place clients into one of three groups based on projected net worth—(i) clients who are *unlikely* to have a taxable estate, (ii) clients who are *likely* to have a taxable estate, and (iii) clients who *might* have a taxable estate.
- Part IV analyzes core estate planning alternatives for clients who might have a taxable estate, including portability, bypass trusts, and disclaimer-based planning.
- Part V analyzes lifetime gifting strategies for clients who might have a taxable estate, including creative uses of a client's lifetime gift tax exemption.
- Part VI offers a few concluding remarks.

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1 Certain sections of this paper originally appeared in a paper authored by Jeff Chadwick and John Bergner in 2020 entitled, *Optimizing Lifetime Gifts*, and presented at the Southern Federal Tax Institute, the Hawaii Tax Institute, the ABA Tax Section, and the Tulsa Estate Planning Forum, among others.

C. Paper Disclaimers

This paper is not intended to be a definitive resource for any one particular planning technique. Rather, it is intended to provide an overview of potential estate planning strategies, with references to more comprehensive resources. This paper is not intended to be, and should not be construed as constituting, the author's opinion with regard to any specific case or transaction or the author's legal or tax advice with respect to any specific case or transaction. The forms included in this paper are for illustrative purposes only and may not be appropriate for any particular client or for use in any particular case or transaction. These forms should be used only by competent counsel as illustrations for potential solutions in specific circumstances.

II. PLANNING IMPACT OF RECENT TRANSFER TAX CHANGES

Before considering specific strategies, advisors must understand the current estate planning landscape, including how the transfer tax exemptions have increased substantially in recent years. In fact, as the number of taxable estates has steadily dwindled advisors must often focus on minimizing income taxes, rather than transfer taxes. The paragraphs below discuss this new paradigm in more detail, including how potential changes in the political landscape may impact transfer tax laws moving forward.

A. Increased Transfer Tax Exemptions, Portability, and Lower Transfer Tax Rates

Recall that in 2000:

- The basic exclusion amount from federal gift and estate taxes (the "BEA") was $675,000 per person;
- The generation-skipping transfer ("GST") tax exemption amount (the "GST Exemption") was $1,030,000 per person;
- The maximum estate and gift tax rate was 55% (with an additional 5% surtax on the value of certain large estates);
- The GST tax rate was 55%; and
- The BEA not used by a deceased spouse was lost and could not be used by the surviving spouse.

A series of tax law changes in 2001, 2010, and 2012 increased the BEA and GST Exemption while also decreasing the transfer tax rates.[2] In 2022, as a result of the Tax Cuts and Jobs Act of 2017 ("TCJA"):

- The BEA is $12,060,000 per person;
- The GST Exemption is $12,060,000 per person;
- The maximum estate and gift tax rate is 40%;
- The GST tax rate is 40%; and

[2] Specifically, Congress enacted the Economic Growth and Tax Relief Reconciliation Act of 2001, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, and the American Taxpayer Relief Act of 2012.

- The BEA not used by a deceased spouse is "portable" and can be used by the surviving spouse.

Even with inflation on the rise, increases to the BEA have far outpaced the rate of inflation. Between January 2000 and April 2022, the consumer price index[3] increased by 71%.[4] By contrast, the BEA (previously not indexed for inflation) increased by 1,787% and the GST Exemption (likewise) increased by 1,171%. Meanwhile, the maximum transfer tax rate decreased by 27%. The BEA and GST Exemption are indexed for inflation in future years.[5]

In short, the federal wealth transfer tax system is no longer relevant to most taxpayers and is significantly less relevant to the remaining few. The table below illustrates the diminishing impact of the federal estate tax:[6]

Year	Estate Tax Exemption Amount	Number of Estate Tax Returns	Number of Estate Tax Returns for Taxable Estates	Percentage of Decedents with Taxable Estates
2001	$675,000	109,600	50,500	2.16%[7]
2008	$2,000,000	29,000	15,100	0.69%
2013	$5,250,000	11,300	4,700	0.18%
2020	$11,580,000	4,100	1,900	0.07%

It is clear that the number of taxpayers impacted by the federal estate tax has rapidly declined in recent years. Consequently, the number of taxpayers motivated to engage in more sophisticated estate planning strategies principally designed to reduce federal estate tax has also rapidly declined.

B. Greater Focus on Income Tax Planning

Although the federal transfer tax burden has decreased, the federal income tax burden for many clients (and trusts) has increased. The maximum federal income tax rate is now 37%. Most affluent taxpayers are also subject to a 3.8% surtax on net investment income and will pay tax on long-term

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3 *See* United States Department of Labor, *Consumer Price Index-All Urban Consumers*, BUREAU OF LABOR STATISTICS, All Items, 1982-84=100 (CPI-U), available at https://www.bls.gov/regions/new-england/data/consumerpriceindex_us_table.htm.

4 From 168.8 in January 2000 to 289.109 in April 2022.

5 *See* IRC § 2010(c)(3)(B).

6 All numbers in this table are approximate. Note also that the estate tax exemption amounts apply to U.S. citizens. The estate tax exemption amount for non-citizens remains at $60,000 per person, not indexed for inflation. The statistics in this table are compiled from a number of sources, including: Internal Revenue Service, *SOI Tax Stats: Estate Tax Year of Death Tables*, available at https://www.irs.gov/statistics/soi-tax-stats-estate-tax-year-of-death-tables; Tax Policy Center, Urban Institute & Brookings Institution, *Key Elements of the U.S. Tax System: How Many People Pay the Estate Tax?*, available at https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax; Institute on Taxation and Economic Policy, *The Federal Estate Tax: An Important Progressive Revenue Source*, available at https://itep.org/the-federal-estate-tax-an-important-progressive-revenue-source/.

7 2.16% is an estimated percentage of taxable estates in 2001 based on figures from the year 2000. *See* Institute on Taxation and Economic Policy, *The Federal Estate Tax: An Important Progressive Revenue Source*, available at https://itep.org/the-federal-estate-tax-an-important-progressive-revenue-source/.

capital gains and dividends at a rate of 20%. Consequently, most affluent taxpayers, including many trusts, could face marginal federal income tax rates as high as 40.8% on ordinary income and 23.8% on long-term capital gains and dividends. For residents in states that impose a state income tax, like California, New York, Louisiana, and Oklahoma, just to name a few, effective income tax rates can be even higher, particularly with the TCJA limiting the federal deduction for state and local taxes to just $10,000.

With the BEA at the highest level ever, the TCJA has created a new paradigm. Planners can no longer assume that removing an asset from the transfer tax base will result in overall tax savings.[8] Rather, for most taxpayers it will be more important to plan for reducing income tax than for reducing transfer tax. The below paragraphs discuss basic income tax planning considerations, which are generally important when advising clients regardless of their estate tax situation.

1. Income Tax Basis

Given the increasing importance of income tax planning for estate planners, it is critical to understand how income tax basis is determined in the wealth transfer context. Internal Revenue Code ("Code") § 1015 generally provides a "carryover" basis for gifted property, meaning that the donee's income tax basis is generally the same as the donor's income tax basis at the time of the gift. If gifted property has an income tax basis greater than fair market value at the time of the gift, then for purposes of determining loss upon a later sale, the donee's income tax basis is limited to the fair market value of the property at the time of the gift. If the property appreciates after the gift, however, the donor's income tax basis in excess of the fair market value at the time of the gift can be used to minimize taxable gain. Meanwhile, for most assets included a client's taxable estate, Code § 1014 provides an income tax basis adjustment, either up or down, to fair market value at the client's date of death. Thus, appreciated property receives a "step-up" at death, while depreciated property receives a "step-down."

For clients in community property states, such as Texas, Code § 1014(b)(6) enhances the potential step-up by providing that both halves of any community property, and not just the one-half interest passing through the deceased spouse's estate, receive an income tax basis adjustment. This has spawned many creative planning techniques designed to facilitate a double step-up for clients who are not domiciled in a community property state, but nonetheless desire to take advantage of community property laws.[9]

For the 99.93% of taxpayers who will not be subject to estate tax under current law, planning should typically focus on preserving the basis step-up for appreciated assets at death, rather than avoiding

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8 David Handler refers to an "appreciation hurdle" as the total net growth required between the date of the lifetime gift and the date of the donor's death for the estate tax savings to exceed the cost of losing the step-up in income tax basis. With some baseline assumptions (including a 40% estate tax rate and a 35% capital gains rate), a gift of a $100 asset with a $0 basis would need to appreciate by 166.667%, such that it grew to $266.67 during the donor's lifetime, in order for the estate tax savings to outweigh the income tax savings. *See* David Handler, *Income Tax Basis: No Longer the Stepchild of Wealth Transfers*, ACTEC 2019 ANNUAL MEETING, p. 13-14.

9 For a general discussion of these planning techniques, including "community property trusts" for out-of-state residents, see Steve Akers, *Heckerling Musings 2019 and Estate Planning Current Developments*, p. 118-120 (April 2019); *see also* Alan S. Gassman, Christopher J. Denicolo, & Kacie Hohnadell, *JEST Offers Serious Estate Planning Plus for Spouses*, 40 EST. PLAN. 3 (Oct. 2013) (discussing a "joint exempt step-up trust"); Austin W. Bramwell, Brad Dillon, & Leah Socash, *The New Estate Planning Lexicon: SUGRITs and Other Grantor-Retained Interest Step-Up Trusts*, 123 J. TAX'N 196 (Nov. 2015) (discussing a variety of creative solutions to achieve basis step-ups upon the first spouse's death).

the estate tax.[10] That has not always been the case, and many clients may have outdated estate plans that no longer make sense under the new planning paradigm. A classic example is a married couple with a modest net worth who executed their estate plan in the early 2000s when the BEA was much lower than it is today. Many of these estate plans create a bypass or credit shelter trust upon the death of the first spouse. While this may have been good, sensible planning in the early 2000s, this estate plan may now generate additional income tax without the offsetting benefit of reduced transfer tax.

2. Downstream Planning

Income tax basis planning generally falls into one of two categories—"downstream" planning or "upstream" planning. Downstream planning refers to techniques designed to ensure that a client's assets are included in his or her own taxable estate before being passed on to family members in the next generation. Upstream planning refers to the transfer of assets to family members in the older generation to be included in the older generation family members' taxable estates for purposes of achieving a higher income tax basis, oftentimes before being passed back down to the current generation.

While a full discussion of downstream planning techniques exceeds the scope of this paper, advisors should consider the following in appropriate circumstances:[11]

- Avoiding lifetime gifts of highly appreciated assets that would not generate estate tax;
- Preserving capital losses by gifting depreciated assets to an individual beneficiary or irrevocable grantor trust;
- Swapping high basis assets, such as a cash, for low basis assets from an irrevocable grantor trust that contains a power of substitution;
- Unwinding valuation discounts for client-owned assets;
- Causing inclusion of irrevocable trust assets in the estate of a settlor, a beneficiary, or a third party's estate;
- Causing inclusion of gifted assets (not in trust) in the donor's estate;
- Converting separate property to community property to facilitate a "double" basis adjustment at each spouse's death; and
- Changing ownership of spousal assets to achieve a new income tax basis for appreciated assets and preserve the income tax basis of loss assets, particularly for clients with a shortened life expectancy.

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10 For an excellent discussion of how to plan to maximize income tax basis in light of the new tax laws, see Lester Law & Howard Zaritsky, *Basis After the 2017 Tax Act – Important Before, Crucial Now*, 53RD ANNUAL HECKERLING INSTITUTE (2019); *see also* Jonathan Blattmachr & Madeline Rivlin, Searching *for Basis in Estate Planning: Less Tax for Heirs*, 41 EST. PLANNING (Aug. 2014); Mickey Davis, *Basis Adjustment Planning,* STATE BAR OF TEXAS 38TH ANN. ADV. EST. PL. & PROBATE COURSE, ch. 10 (2014).

11 For a more complete discussion of these techniques, see John Bergner, *Oh, What a Relief It Is: Curing Estate Plans that No Longer Make Sense in Light of the American Taxpayer Relief Act of 2012*, 49TH ANNUAL HECKERLING INSTITUTE (Jan. 13, 2015), available at http://www.tulsaepf.org/assets/Councils/Tulsa-OK/library/Bergner%20Materials.pdf.

3. Upstream Planning

Upstream planning can potentially benefit a client who owns assets with substantial appreciation and has an older family member, such as a parent, who has "excess" BEA. The client can create an irrevocable trust for the benefit of a parent and fund the trust with the appreciated assets. The trust is designed to ensure that the appreciated assets are includable in the parent's estate by granting the parent a testamentary power to appoint the trust's assets to the parent's creditors. Upon the parent's death, the lapse of the parent's general power of appointment should cause the assets to be included in the parent's taxable estate, under Code § 2041, entitling the appreciated assets to a basis step-up. The inclusion of the appreciated assets in the parent's estate should facilitate the use of the parent's BEA and GST Exemption, while reducing future capital gains tax. The default beneficiary upon the lapse of the parent's general power of appointment is generally a GST exempt trust for the benefit of the client or the client's family members, which is often designed to be protected from the claims of creditors and divorcing spouses.

Upstream planning is not without risk. One particular risk is Code § 1014(e), which disallows a basis step-up if appreciated property is gifted to a parent (or any other person), but the parent dies within one year of the gift and the property returns to the donor. Code § 1014(e) would not apply, however, if the appreciated property passed to a person other than the donor (*e.g.*, a trust for the donor's descendants). It is also possible that Code § 1014(e) would not apply if the property passed to a trust that included the donor as a permissible beneficiary. The IRS could also assert that any assets that return to a trust for the benefit of the client should be included in the client's taxable estate under Code § 2036 or § 2038. In any event, with today's focus on income tax planning for many clients, upstream planning should continue to be a viable option in appropriate circumstances.[12]

C. <u>Sunset of Increased Transfer Tax Exemptions</u>

If the increases to the BEA and GST Exemption were permanent, it would be easier to plan for clients. Of course, nothing is ever really permanent when it comes to the estate tax. The TCJA reinforced this notion by expressly providing that the doubled exemptions are only temporary. Absent a statutory change, the doubled exemptions are set to expire at the end of 2025, with the BEA and GST Exemption returning to $5 million per person in 2026, indexed for inflation with a base year of 2016.[13] Factoring in inflation, this paper assumes that the BEA and GST Exemption in 2026 will be approximately $7 million.

Part of the difficulty in gift planning between now and 2026 is that the doubled exemptions are "use it or lose it" amounts. In other words, when a taxpayer makes a lifetime gift, the BEA comes off the bottom, and not the top. For example, assuming the BEA drops to $7 million in 2026, if a taxpayer makes a $6 million gift in 2025, and has made no other taxable gifts in prior years, the taxpayer would only have $1 million of BEA remaining in 2026. Thus, the taxpayer would have to make gifts in excess of $7 million before 2026 to receive any benefit from the temporarily doubled exemptions. Few taxpayers are in a financial position to make gifts of this magnitude, yet if the law does not change, many will consider creative gifting strategies in 2025.

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[12] For a general discussion of upstream planning, see Steve Akers, *Heckerling Musings 2019 and Estate Planning Current Developments*, p. 59 (April 2019); *see also* John F. Bergner, *Waste Not: Creative Use of General Powers of Appointment to Fund Tax-Advantaged Trusts*, 41[ST] ANNUAL HECKERLING INSTITUTE (2007) (discussing the use of general powers of appointment to fund spousal trusts designed to minimize overall tax burdens).

[13] *See* IRC § 2010(c)(3) (setting the BEA); IRC § 2631(c) (setting the GST Exemption by cross-reference to the BEA).

In many ways, planning in 2025 could look a lot like planning in 2012, when the $5 million BEA and 35% tax rate were set to expire and be replaced in 2013 with a $1 million BEA and 55% tax rate. One silver lining this time around is that the IRS, through the issuance of final Regulations in 2019, has removed any fear of "clawback" if a taxpayer makes a lifetime gift prior to 2026 that utilizes BEA available at the time of the gift, but not available at the time of the taxpayer's death.[14] Consider, for example, a taxpayer who makes an outright gift of $9 million in 2022, all of which is sheltered by the taxpayer's BEA. If the taxpayer later dies in 2026, when the BEA is $7 million, the final Regulations generally provide that the taxpayer's BEA, for purposes of calculating any estate tax due, will be calculated as if it were $9 million, rather than $7 million.[15] As a result, the taxpayer's prior gifts in excess of the taxpayer's BEA at the time of his death should not be "clawed back" to produce a higher estate tax liability.

D. <u>Potential Legislation</u>

Clients often ask what will happen with the estate tax. It is very tempting to respond, "I don't know," and leave it at that, but clients expect a more detailed answer. Moreover, providing a detailed analysis of potential legislation should help clients better understand certain planning recommendations, which should enable them to make more informed decisions. When engaging in this discussion with clients, planners generally walk through the following scenarios.

1. Estate Tax Repeal?

In 2016 when Donald Trump was elected President and the Republicans won both houses of Congress, rhetoric surrounding estate tax repeal reached a fever pitch. After all, Trump campaigned on repealing the "death tax"[16] and through the years many Republicans, mostly from rural farmland communities, had, themselves, introduced bills to repeal the estate tax.[17] It seemed like the perfect storm. And yet, even after the sweeping changes to the tax system ushered in by the TCJA, the transfer tax system remained, albeit with doubled exemptions for a seven-year window from 2018 through 2025.

Depending on what happens with the next election cycle, rumors of estate tax repeal may continue to surface from time to time.[18] Any discussion with clients, however, should start with reminding them that, except for a transition year in 2010, the estate tax has existed in some form or fashion since 1916, having been repealed and reinstated several times. Consequently, and at the risk of being completely wrong, it seems unlikely that the estate tax will be repealed any time soon.

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14 *See* Treas. Reg. § 20.2010-1(c).

15 *See* Treas. Reg. § 20.2010-1(c)(2)(i).

16 *See* Ashlea Ebeling, *Will Trump Victory Yield Estate Tax Repeal?*, FORBES, Nov. 9, 2016, available at https://www.forbes.com/sites/ashleaebeling/2016/11/09/will-trump-victory-yield-estate-tax-repeal/#4fcb383528a5.

17 In January 2019, Senate Republican John Thune, from South Dakota, reintroduced legislation to repeal the estate tax. The legislation was co-sponsored by a number of key Republican leaders, including Senate Majority Leader Mitch McConnell and Senate Finance Committee Chairman Chuck Grassley. *See* Naomi Jagoda, *Senate Republicans Reintroduce Bill To Repeal the Estate Tax*, THE HILL, Jan. 28, 2019, available at https://thehill.com/policy/finance/427328-senate-republicans-reintroduce-bill-to-repeal-the-estate-tax. Joey Arrington, a Republican member of the House Ways and Means Committee, introduced H.R. 5652 in January 2020 to reduce the estate, gift, and GST tax rates to a flat 20%. To date, this bill has not gained any traction.

18 In January 2020, for example, Joey Arrington, a Republican member of the House Ways and Means Committee, introduced H.R. 5652 to reduce the estate, gift, and GST tax rates to a flat 20%. The bill failed to gain any traction.

2. Build Back Better Act

The political pendulum swung in 2020, when Joe Biden was elected President and the Democrats took control of both houses of Congress. In sharp contrast to the previous administration, which sought to reduce taxes across the board, the Biden administration sought to increase taxes on the wealthy as a means to support additional government spending for broader social programs. After much discussion and speculation, the House Ways & Means Committee released draft legislation on September 12, 2021, popularly known as the Build Back Better Act. Although the Build Back Better Act ultimately failed to pass, it was enough to send clients and estate planning advisors into a frenzy, while also offering a glimpse into potential Democratic tax legislation.

The major tax provisions of the Build Back Better Act are summarized below:[19]

- **Accelerated Reduction of Transfer Tax Exemptions**. The bill sought to reduce the BEA and GST Exemption to $5 million, subject to inflation, for gifts made or individuals dying, after December 31, 2021. In other words, the 2026 sunset would have been accelerated to 2022.

- **Elimination of Grantor Trust Benefits**. The bill also proposed to eliminate the estate planning benefits of grantor trusts. Specifically:

  - Assets owned by a grantor trust would have been included in the grantor's estate and subject to estate tax upon the grantor's death;

  - Distributions from a grantor trust during the grantor's lifetime would have been treated as taxable gifts;

  - If grantor trust status is terminated, the grantor would have been deemed to make a taxable gift of the trust assets; and

  - Transfers between a grantor trust and its grantor would have been subject to income tax regardless of when the grantor trust was created.

  House Report No. 117-130, released by the House Budget Committee to help explain the intent of the Build Back Better Act, clarified that these rules would have applied to all post-enactment transfers between a grantor and grantor trust, including grantor trusts created prior to the date of enactment. Therefore, a sale or swap of assets after the legislation's effective date between a pre-enactment grantor trust and its grantor would have been an income tax realization event. Likewise, a GRAT annuity payment made in kind with appreciated assets to the grantor after the legislation's effective date would have been an income tax realization event.

- **No Valuation Discount for Nonbusiness Assets**. Under the proposed legislation, the opportunity to claim valuation discounts when a taxpayer transfers certain business interests that own "nonbusiness assets" would have been eliminated. These nonbusiness assets, such as cash, stocks, bonds, and real property (with exceptions for certain active

[19] For a more thorough description of the Build Back Better Act, see Winstead PC, *Update – Tax Proposals of the House Ways and Means Committee: Reconciliation Bill to Target Trusts, Estates, and the Wealthy*, October 5, 2021, available at [Update - Tax Proposals of the House Ways and Means Committee: Reconciliation Bill to Target Trusts, Estates, and the Wealthy - Winstead PC]().

real estate trades and businesses), would have been valued as if the transferor transferred such assets directly to the transferee at full fair market value. This proposal would have applied to all transfers made after the date of enactment.

- **Tax Increases for High-Income Taxpayers**. The Build Back Better Act included a number of tax hikes for high-income taxpayers, summarized below:
    - The top marginal rate income tax rate would have increased from 37% to 39.6% for individuals, trusts, and estates.
    - The top income tax rate for long-term capital gains would have increased from 20% to 25%.
    - Trusts and estates with income over $100,000 would have been subject to a 3% surcharge tax based upon their modified adjusted gross income ("AGI"). This 3% surcharge tax would have also applied to individual taxpayers, whether single or married, with modified AGI in excess of $5 million. For married individuals filing separately, the 3% surcharge tax would have applied to modified AGI in excess of $2.5 million.
- **Limitations on the Qualified Small Business Stock Exclusion**. Currently, taxpayers may exclude a specific percentage of capital gain from income when selling qualified small business stock ("QSBS"). Under the Build Back Better Act, taxpayers with AGI of $400,000 or more and all trusts and estates would have only been allowed to exclude 50% of the eligible gain.

E. Advising in the Face of Uncertainty: Remember the Status Quo

As discussed above, if Congress does nothing between now and 2026, the BEA and GST Exemption will return to $5 million per person, indexed for inflation with a base year of 2016. Without knowing who will occupy the White House or control Congress over the next four years, the status quo may be the betting favorite. Recall that the BEA is estimated to be approximately $7 million per person in 2026, so that is probably a good number to start with when planning for clients. No one can predict the future, however, so planners must recognize that any speculation regarding the federal transfer tax system, or even the future health of clients, is just that.

III. THREE GROUPS OF CLIENTS BASED ON PROJECTED NET WORTH

Before designing a client's estate plan, advisors should seek to gain a comprehensive understanding of the client's current financial status (including any assets excluded from the client's taxable estate), appreciation potential, and remaining BEA and GST Exemption. This information should enable the advisor to place the client in one of three groups—(i) clients who are *unlikely* to have a taxable estate, (ii) clients who are *likely* to have a taxable estate, and (iii) clients who *might* have a taxable estate.

Of course, these three client groups are moving targets, and any attempt to categorize clients based on current financial and tax circumstances is an inexact science. For example, unexpected increases or decreases to a client's net worth could make certain strategies more or less attractive, while changes to the transfer tax laws could materially impact a client's taxable posture. Not only is it important that the advisor learn as much as possible about the client's financial position at the outset of the relationship, the advisor, to the extent possible, should also seek to monitor changes to the client's financial circumstances over time that would merit an update to the client's estate plan and gifting strategy.

As further described below, different tax planning strategies will be appropriate for each group of clients. Moreover, advisors should recommend specific tax planning strategies only after considering the client's non-tax objectives, including the client's tolerance for complexity, transaction costs, and potential loss of control, among other factors.

A. Clients Who Are Unlikely to Have a Taxable Estate

Recall that, in 2026, the BEA is set to return to $5 million per person, which is estimated to be $7 million per person after adjusting for inflation. Certain clients are unlikely to ever have a $7 million net worth, much less a $14 million net worth for a married couple. Estate planning for this group usually focuses on the client's non-taxable objectives, such as who should inherit property upon the client's death and in what manner.

To the extent a client in this group wishes to make a lifetime gift, the gift is typically intended to satisfy a beneficiary's specific need or desire, rather than reduce transfer taxes. Advisors should consider the potential income tax consequences associated with any such gifts. Because the client is unlikely to have a taxable estate, it is typically more important to minimize income taxes, rather than to plan for transfer taxes.

If a client in this group makes a taxable gift, advisors should be prepared for the inevitable question from the client, "if I do not owe any gift tax, why do I have to file a gift tax return?" Although there is no monetary penalty for filing a late gift tax return when there is no tax due, filing the return is nonetheless a legal requirement. Advisors can also remind clients that filing a gift tax return helps track the use of their BEA and GST Exemption, which would be helpful if changes to the law or their net worth later subjected them to the transfer tax system.

B. Clients Who Are Likely to Have a Taxable Estate

Some clients have a taxable estate under today's law, and are likely to have a taxable estate as long as the estate tax exists. Specifically, these clients have a net worth today in excess of $12.06 million, or in excess of $24.12 million for a married couple. For married clients in this situation, most advisors will still structure their core estate plans with a traditional bypass or credit shelter trust upon the death of the first spouse in an effort to reduce overall transfer taxes. For clients who have a net worth that greatly exceeds these figures, it may be appropriate for the client to make substantial lifetime gifts to further reduce transfer taxes.

Clients who are likely to have a taxable estate may be in a position to make substantial lifetime gifts, without requiring much flexibility or access to capital. For example, a married couple with a net worth of $100 million may be able to give their entire BEA to a trust for the benefit of their children and grandchildren, without the need to consider more creative strategies such as spousal lifetime access trusts. Some clients, however, regardless of their net worth, may never be comfortable making substantial lifetime gifts for fear of needing the money at some distant point in the future.

In many respects, planning for clients who are likely to have a taxable estate is business as usual for many advisors. While it exceeds the scope of this paper to provide a complete explanation of transfer tax reduction strategies, advisors should consider the following techniques, among others:

- Outright gifts to descendants and other beneficiaries;

- Gifts to grantor trusts for the benefit of spouses, descendants, and/or other individuals;
- Installment sales to grantor trusts;
- GRATs;
- Remainder Purchase Marital Trusts ("RPM Trusts");[20]
- QPRTs and split purchase QPRTs ("SP-QPRTs");[21]
- ILITs;
- Beneficiary deemed owned trusts ("BDOTs");[22]
- Charitable lead trusts ("CLTs") and charitable remainder trusts ("CRTs");
- Family limited partnerships ("FLPs");
- Intra-family loans and loan forgiveness;[23]
- Private annuities;
- For spouses with a significant disparity in wealth, elect gift splitting for the wealthier spouse's gifts to facilitate the use of both spouses' BEAs and GST Exemptions;[24] and
- In rare circumstances, making gifts to intentionally trigger a gift tax to take advantage of the tax-exclusive nature of the gift tax compared to the tax-inclusive nature of the estate tax.

Most strategies attempt to "freeze" the value of the client's taxable estate by transferring an appreciating asset, which would otherwise generate additional estate tax (if it remained in the client's estate), to an irrevocable trust that should be excluded from the client's estate. In other words, a client can freeze the value of his taxable estate by shifting future appreciation to an estate tax protected vehicle.

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20 *See* S. Stacy Eastland, *A Comparison of the Best Freeze Planning Techniques We See Out There in the Age of Tax Reform*, 2019 ACTEC ANNUAL MEETING, p. 101 (2019); *see also* David Handler, *Creative GRAT Structures and RPM Trusts*, ESTATE PLANNING COUNCIL OF PORTLAND (May 13, 2015), available at http://www.epcportland.org/assets/Councils/Portland-OR/library/David%20Handler%20Written%20Materials.pdf.

21 *See* John F. Bergner, *Estate Planning Gems*, HAWAII TAX INSTITUTE (Nov. 6, 2017).

22 *See* S. Stacy Eastland, *A Comparison of the Best Freeze Planning Techniques We See Out There in the Age of Tax Reform*, 2019 ACTEC ANNUAL MEETING (2019).

23 *See* Steve Akers & Phillip Hayes, *Estate Planning Issues with Intra-Family Loans and Notes*, ABA RPTE MEETING (Feb. 2014), available at https://www.americanbar.org/content/dam/aba/publishing/rpte_ereport/2014/1_february/te_akers.authcheckdam.pdf.

24 For further discussion of this and two additional techniques to utilize both spouses' BEAs and GST Exemptions, see Richard S. Franklin & George D. Karibjanian, *The Lifetime QTIP Trust – the Perfect (Best) Approach to Using Your Spouse's New Applicable Exclusion Amount and GST Exemption*, BLOOMBERG ESTATES, GIFTS, AND TRUSTS, NUMBER 2 (Mar. 14, 2019).

Many gifting strategies for this group of clients also attempts to "leverage" the use of the client's BEA and GST Exemption by relying on valuation discounts for transfer tax purposes. Such valuation discounts generally include fractional interest, minority interest, and/or lack of marketability discounts, among many others.

It can be hard to achieve certainty when gifting hard-to-value property, such as real estate, artwork, or a closely held business interest. To avoid making too large a gift and unintentionally incurring out-of-pocket gift tax, clients can utilize formula clauses in their gift documents, such as defined valued clauses,[25] or structure gifts with the beneficiary executing a disclaimer of any amount that exceeds the donor's remaining BEA, with the disclaimed amount returning to the donor or the donor's estate.[26] Each of these techniques attempts to achieve a gift of a specific dollar amount, with a built-in adjustment to the percentage interest actually gifted in case of an IRS audit. One of the practical benefits of the temporarily doubled BEA and GST Exemption, beyond the increased amounts themselves, is the ability for clients to make significant gifts of property that is hard to value, but that the client is comfortable has a value well below the client's remaining BEA. This extra cushion can oftentimes alleviate the need for a complex formula clause in the client's gifting documents.[27]

Clients who are likely to have a taxable estate often ask advisors whether they should utilize the doubled exemptions now or defer planning until 2025. On the one hand, deferred planning provides the client with more flexibility by retaining ownership of the assets. On the other hand, gifting assets now removes future income and appreciation from the client's taxable estate and, if the assets are transferred to a grantor trust, facilitates a greater potential wealth shift through the client's payment of income tax generated by the trust assets. Many clients in this situation decide to utilize the doubled exemptions now, rather than waiting until 2025, and may already have existing trusts that are appropriate vehicles for such gifts.

C. <u>Clients Who Might Have a Taxable Estate</u>

Some clients do not have a taxable estate today, but could have a taxable estate in the future, either because the doubled BEA expires or the client's net worth outpaces their future BEA. Consider, for example, a married couple with a $20 million net worth. These clients do not have a taxable estate in 2022, but they are projected to have a taxable estate if the BEA drops to $7 million per person in 2026. In addition, even if the doubled BEA is extended beyond 2026, their net worth could grow to a point where they have a taxable estate upon the death of the surviving spouse.

When planning for the three different groups of clients, these proverbial middle children present the most challenges. Unlike clients who should always have a taxable estate, this middle group of clients cannot afford to give away the bulk of their net worth just to make use of the currently doubled BEA. Recall that, because BEA comes off the bottom and not the top, a client only begins to experience the benefit of the doubled BEA when the client's gifts exceed an estimated $7 million (or $14 million combined if both spouses are making equal gifts). On the other hand, unlike clients who are unlikely to ever have a taxable estate, this middle group of clients may face substantial estate tax without proper

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[25] *See* Paige K. Ben-Yaacov, *Formula Clauses: Are Two Donees Better than One?*, 29 PROBATE & PROPERTY 6 (2015).

[26] *See* Ann B. Burns, *They Say You Can't Take it With You – But How Do You Give It Away? Using the $5 Million Exclusion Amount*, 46TH ANNUAL HECKERLING INSTITUTE, p. 32-33 (Jan. 2012).

[27] Steve Akers refers to this as the "cushion effect." *See* Steve Akers, *Heckerling Musings 2019 and Estate Planning Current Developments*, p. 60 (April 2019).

planning. GST planning for these clients is especially important given that the GST Exemption is set to drop to approximately $7 million in 2026, and unlike the BEA, is not portable between spouses.

The remainder of this paper focuses on planning for clients who might have a taxable estate, starting first with the client's core estate plan before shifting to potential lifetime gifting strategies. These clients face difficult choices, and our job as advisors is to help them make informed decisions while also maintaining flexibility to respond to potential changes in their financial circumstances and the tax laws.

IV. CORE ESTATE PLANNING FOR CLIENTS WHO MIGHT HAVE A TAXABLE ESTATE

For most new clients, advisors should start with their "core" estate plan. These are the documents that govern the disposition of assets upon a client's death, such as a pour-over Will and revocable living trust, as well as the appointment of agents to make medical and financial decisions for the client if the client becomes incapacitated during lifetime, such as medical and financial powers of attorney. In many cases, a new client will not have a core estate plan. In other cases, a new client will have a core estate plan, but it is outdated. Even if a new client has a good core estate plan already in place, it is best to work through and confirm this plan, which the client can always change later in life, before transitioning to any irrevocable gifting strategies.

Explaining the federal transfer tax system to clients who might have a taxable estate is no easy task. It is at least a little easier, however, for single clients compared to married clients, because the unlimited marital deduction from federal estate taxes, and its many nuances, only applies to married clients. Single clients, therefore, have the benefit of focusing on a single set of potential tax consequences upon the client's death, while married couples must navigate two sets of potential tax consequences upon each spouse's death. Given these additional complexities, the below discussion of core estate planning techniques focuses primarily on advising married couples.

A. Explaining the Federal Transfer Tax System to Married Couples

After learning about a client's family, finances, and basic estate planning objectives, an advisor must then explain how the federal transfer tax system might apply to the client's proposed disposition of assets. In the author's experience, this process can take anywhere from five minutes to five years, and the entire explanation is subject to change at any time based upon corresponding changes in the tax laws or the client's financial situation.

When meeting with a new client, we typically begin by explaining how estate planning for married couples has traditionally revolved around utilizing, to the fullest extent possible, the BEA of the first spouse to die at the time of the first spouse's death. Before 2010, if the first deceased spouse's BEA was not fully utilized, such unused amount would be wasted. Typically, spouses intending to minimize estate tax would structure their estate plans to provide that upon the first spouse's death, assets of the deceased spouse's estate having a date-of-death value up to the deceased spouse's BEA would be administered in an irrevocable bypass or credit shelter trust for the primary benefit of the surviving spouse (referred to in this Section as a "Family Trust").

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 introduced the concept of "portability," which permits married couples to take advantage of both spouses' BEAs without the need for traditional Family Trust planning at the first spouse's death. With portability, upon the death of the first spouse to die, the surviving spouse can utilize or "port" the unused portion of the deceased spouse's BEA. Consequently, the first spouse to die can leave all assets to his or her surviving spouse, outright and free of trust, or in a trust qualifying for the unlimited marital deduction (referred to in this Section as a "Marital Trust"), rather than utilizing a traditional Family Trust. For example, if the first spouse were to die in 2022 without using any of his or her BEA, the surviving spouse could port the deceased spouse's unused BEA ($12.06 million) by adding it to the surviving spouse's own BEA ($12.06 million), resulting in a $24.12 million "Applicable Exclusion Amount," or "AEA," available to the surviving spouse.

Portability was designed to simplify the estate planning process for married couples by eliminating the need to implement complicated Family Trust planning in many circumstances. Ironically, the author has found that after portability, many of his meetings with new estate planning clients are now much longer than before simply because the clients now have a number of options, compared the rather narrow technique of the traditional Family Trust.

The remaining paragraphs of this Section analyze the major core estate planning alternatives for married couples upon the first spouse's death, including a discussion of primary advantages and disadvantages to each approach.[28] Attached as Exhibit 1 is a sample client memorandum providing an overview of the federal transfer tax system, the income tax basis adjustment, and portability.

B. All Assets to Surviving Spouse Outright

With the advent of portability, the first option for married clients who might have a taxable estate is leaving all assets to the surviving spouse outright and free of trust.

1. Advantages

There are several advantages to this approach, outlined below:

- **Simplicity**. An outright disposition to the surviving spouse is extremely simple and often aligns with the client's intent. The surviving spouse is not required to administer an irrevocable trust (a Family Trust and/or Marital Trust), which would require the filing of a separate annual income tax return.

- **No Fiduciary Responsibility**. With an outright disposition, the surviving spouse is not required to assume a fiduciary role. By contrast, assuming the surviving spouse serves as trustee of a Family Trust and/or Marital Trust, the surviving spouse owes fiduciary duties to the current and remainder beneficiaries of such trusts, which are often the deceased spouse's children or other family members.

- **Double Income Tax Basis Adjustment**. Most assets included in the deceased spouse's taxable estate (including both halves of community property) receive an income tax basis adjustment to fair market value at the date of the deceased spouse's death. By passing assets to the surviving spouse outright, most assets should receive a second basis adjustment at the surviving spouse's death. By contrast, the assets held inside a Family Trust only receive a basis adjustment at the death of the first spouse, and do not typically receive a basis adjustment at the surviving spouse's death.

- **Good for Large Retirement Plans**. In most cases, a client chooses to name his or her surviving spouse as the outright beneficiary of IRAs and 401ks, which permits the surviving spouse to optimize income tax deferral opportunities. It is difficult to design a

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[28] For a similar analysis of estate planning decisions for married couples, see Mickey Davis, *Basis Adjustment Planning,* STATE BAR OF TEXAS 38TH ANN. ADV. EST. PL. & PROBATE COURSE, ch. 10 (2014).

traditional Family Trust in the same manner. Portability, therefore, is particularly well-suited for clients who have a substantial portion of their net worth in retirement plans.

2. Disadvantages

Despite its simplicity and income tax advantages, an outright disposition to the surviving spouse has several disadvantages, outlined below:

- **Requirement to File Estate Tax Return**. A surviving spouse cannot port a deceased spouse's unused BEA without preparing and filing a federal estate tax return. While special rules permit executors filing a return for portability purposes only to estimate the value of certain property in the deceased spouse's estate,[29] even the simplest return requires some time and expense.

- **Unused BEA Could Be Lost**. A surviving spouse is only allowed to use the BEA of his or her last deceased spouse.[30] Consequently, if the surviving spouse remarries and the new spouse dies before the surviving spouse has utilized the unused BEA of the first spouse to die, the surviving spouse would lose the first deceased spouse's unused BEA.

- **No Creditor or Spousal Protection**. Unlike a Family Trust or Marital Trust, assets received outright by a surviving spouse are left exposed to the potential claims of creditors. In addition, a surviving spouse can dispose of assets received outright from the deceased spouse without limitation (*e.g.*, to some children to the exclusion of others, to a new spouse, to influential caregivers, or to charitable or other organizations).

- **GST Exemption Not Portable**. Unlike the BEA, the GST Exemption is not portable between spouses. For clients who might have a taxable estate and wish to engage in multi-generational planning, especially when compared to clients who are unlikely to have a taxable estate, this is a significant detriment to relying solely on portability.

- **Future Appreciation Subject to Estate Tax**. If the surviving spouse does have a taxable estate, the unused BEA is not indexed for inflation and the assets are not held inside a Family Trust where future appreciation also escapes the federal estate tax. Therefore, leaving all assets to the surviving spouse outright could increase total estate tax due upon the surviving spouse's death.

C. First Spouse's Remaining BEA to Family Trust

At the other end of the spectrum, some married clients who might have a taxable estate may still prefer to create and fund a traditional Family Trust upon the death of the first spouse.

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[29] *See* Treas. Regs. § 20.2010-2(a)(7)(ii); *see also* IRS Instructions for Form 706 (Rev. September 2021), page 18, available at https://www.irs.gov/pub/irs-pdf/i706.pdf (providing a table of value ranges an executor can rely upon when estimating the value of the deceased spouse's assets).

[30] *See* IRC § 2010(c)(4).

1. Advantages

There are several advantages to funding a Family Trust with the deceased spouse's remaining BEA:

- **Shield Future Income and Appreciation from Estate Tax**. When a surviving spouse ports the deceased spouse's BEA, such unused BEA remains fixed and is not indexed for inflation. By contrast, the assets of a Family Trust should pass free of estate tax at the surviving spouse's death, including all accumulated income in the Family Trust and all appreciation in the trust assets since the death of the first spouse. A traditional Family Trust may be more appropriate, therefore, if the client's assets have significant appreciation potential, such as interests in a closely held business or private equity fund.

- **Creditor and Spousal Protection**. Unlike assets given to a surviving spouse outright, a Family Trust can provide creditor protection for the surviving spouse while also limiting the surviving spouse's ability to transfer assets outside the family line. Married couples can generally achieve a similar level of creditor and divorce protection with a Marital Trust, as further discussed below.

- **Can Benefit Other Family Members**. The beneficiaries of a Family Trust typically include children and more remote descendants, in addition to the surviving spouse. Many surviving spouses value the ability to make discretionary distributions to descendants, which can be further enhanced by giving the surviving spouse a lifetime power, exercisable in a non-fiduciary capacity, to appoint the trust assets to or among descendants for any purpose whatsoever.

- **Can Utilize GST Exemption**. The deceased spouse's GST Exemption can be allocated to the Family Trust and enable those assets, plus accumulated income and appreciation, to pass free of transfer taxes for multiple generations.

- **Hardwired Funding**. Other techniques further discussed below, such as disclaimer-based planning, rely on specific action from the surviving spouse or a fiduciary to maximize their effectiveness for transfer tax purposes. While these plans may be solid in theory, clients may not fully understand or appreciate the nuances involved in making the various elections, particularly when mourning the loss of a loved one. One advantage to funding a traditional Family Trust, therefore, is ensuring that the deceased spouse's BEA is utilized regardless of what may take place after the first spouse's death.

- **May Not Be Required to File Estate Tax Return**. If the deceased spouse's estate is less than his or her BEA, all assets can pass to a Family Trust without the need to file a federal estate tax return for the deceased spouse's estate. Despite this, it may still be prudent to file a return in order to port the deceased spouse's unused BEA, depending on the circumstances.

2. Disadvantages

There are several potential disadvantages to passing the deceased spouse's remaining BEA to a Family Trust, outlined below:

- **Complexity**. Some surviving spouses simply do not have the appetite for the complexity involved in funding and administering a Family Trust at the first spouse's death. In addition to transferring and retitling assets, the trustee of the Family Trust must file an annual income tax return for the trust.

- **Increased Income Tax Exposure**. As a general matter, trusts reach the highest income tax bracket much quicker than individuals. For example, in 2022 trust income over $13,450 is subject to the top income tax rate of 37%, in addition to a 3.8% surtax on net investment income. The surviving spouse would only reach this top bracket after earning $539,900 of income or $200,000 of net investment income. In addition, unless complex and relatively untested provisions are included in the trust agreement, assets owned by the Family Trust at the surviving spouse's death generally do not receive an income tax basis adjustment, which could increase total capital gains. Overall, individual ownership is generally much more advantageous than trust ownership from an income tax perspective.

- **Fiduciary Responsibility**. The trustee of the Family Trust, which is typically the surviving spouse, owes fiduciary duties to the current and remainder beneficiaries, such as children and more remote descendants. By contrast, when a surviving spouse receives assets outright, the surviving spouse owes no such fiduciary duties.

D. <u>All Assets to Marital Trust</u>

Some married clients choose to leave substantially all of the deceased spouse's assets to a Marital Trust for the benefit of the surviving spouse, rather than leaving assets to the surviving spouse outright or utilizing a Family Trust at the first spouse's death. With this alternative, the Marital Trust should be structured in a manner that the executor of the deceased spouse's estate may make a qualified terminable interest property ("QTIP") election so that the trust property qualifies for the unlimited marital deduction.

1. Advantages

In comparison to other techniques, there are several advantages to utilizing a Marital Trust:

- **Creditor and Spousal Protection**. Similar to a Family Trust, a Marital Trust can provide creditor protection for the surviving spouse while also limiting the surviving spouse's ability to transfer assets outside the family line. When assets are left to a surviving spouse outright, there are no restrictions on the surviving spouse's ability to dispose of the property.

- **Better Income Tax Treatment**. To qualify for the QTIP election, the trustee of the Marital Trust must distribute all net income to the surviving spouse in annual or more frequent installments.[31] Because all fiduciary accounting income must be distributed from the Marital Trust to the surviving spouse, less income should be trapped inside the Marital Trust and subject to the more compressed income tax brackets discussed above. In addition, because the assets of a Marital Trust are included in the surviving spouse's taxable estate,[32] the assets should receive a second income tax basis adjustment upon the

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[31] *See* IRC § 2056(b)(7)(B).

[32] *See* IRC § 2044.

surviving spouse's death, as is the case with assets owned by the surviving spouse outright.

- **Flexibility to Make QTIP Election or Not**. For the Marital Trust to qualify for the estate tax marital deduction, the executor of the deceased spouse's estate must generally make the QTIP election on a timely filed federal estate tax return. Because the estate tax return is not due until nine months after the death of the first spouse, or fifteen months under extension, this permits the surviving spouse (or the executor, if other than the surviving spouse) to evaluate the circumstances that exist upon the first spouse's death and determine whether it makes more sense to make the QTIP election or not. Making the QTIP election ensures that the assets passing to the Marital Trust qualify for the unlimited marital deduction, while failing to make the QTIP election would consume the deceased spouse's BEA. The executor can even make a partial QTIP election so that some, but not all, of the Marital Trust assets qualify for the marital deduction. Added flexibility is always a positive.

- **Can Utilize GST Exemption**. Recall that the GST Exemption is not portable between spouses and the deceased spouse's GST Exemption can be wasted if a surviving spouse receives all assets outright. A Marital Trust, however, can effectively utilize the deceased spouse's GST Exemption. If the executor of the deceased spouse's estate does not make a QTIP election, the deceased spouse is deemed the transferor of the Marital Trust assets for GST tax purposes, which permits the executor to allocate the deceased spouse's GST Exemption to the property.[33] Even if a QTIP election is made, the executor can make a "reverse" QTIP election for GST tax purposes, which again permits the executor to allocate the deceased spouse's GST Exemption.[34] In short, using a Marital Trust should help preserve the GST Exemption of both spouses, unlike an outright bequest to the surviving spouse.

- **Testamentary Power of Appointment**. Unlike disclaimer-based planning, as further discussed below, the surviving spouse can retain the power to appoint the remaining property of the Marital Trust upon his or her death. Oftentimes the surviving spouse's ability to appoint the property is limited to a certain class of permissible appointees, such as descendants of the deceased spouse and charity. This testamentary limited power of appointment gives the surviving spouse great flexibility to alter the passage of assets among certain individuals based on the circumstances or even eliminate the federal estate tax altogether by appointing assets to charity.

2. Disadvantages

Despite its many advantages, there are several disadvantages to using a Marital Trust:

- **Complexity**. Funding and administering a Marital Trust is more complex than leaving all assets to the surviving spouse outright. Even though a Marital Trust should be a simple trust for federal income tax purposes, the trustee must still maintain separate books and records, and also file annual federal income tax returns for the trust.

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33 *See* IRC § 2632(e)(1)(B)

34 *See* IRC § 2652(a)(3).

- **Fiduciary Responsibility**. Like a Family Trust, a Marital Trust creates a fiduciary relationship in which the trustee owes fiduciary duties to the trust's beneficiaries, including its remainder beneficiaries. Many remainder beneficiaries have become plaintiffs in lawsuits, particularly in blended family situations. Again, when a surviving spouse receives assets outright, the surviving spouse is not a fiduciary and assumes no fiduciary duties.

- **Cannot Benefit Other Family Members During Lifetime**. To qualify for the QTIP election, the surviving spouse must be the only beneficiary of the Marital Trust during the surviving spouse's lifetime.[35] Thus, the trustee has no ability to make trust distributions to other family members while the surviving spouse is alive. Rather, if the surviving spouse desires to use the assets of the Marital Trust to benefit another family member, the surviving spouse must first receive a trust distribution, then make a taxable transfer to such family member. With a Family Trust, by contrast, other family members can receive trust distributions without an additional transfer tax hurdle.

- **Future Appreciation Subject to Estate Tax**. To the extent the QTIP election is made, the assets of the Marital Trust, including all future appreciation, will be included in the surviving spouse's taxable estate upon death. If the trust assets substantially appreciate during the surviving spouse's lifetime, the total tax due could be significantly more than if such appreciation were shielded by a Family Trust.

- **Distributed Income Subject to Estate Tax**. Even if a full QTIP election is not made, the trustee of the Marital Trust must still distribute net income to the surviving spouse. In this scenario, the assets of the Marital Trust would not be included in the surviving spouse's taxable estate (because the QTIP election was not made), but income would still be distributed to the surviving spouse and potentially subject to estate tax. Some planners refer to this as a "leaky" trust for federal estate tax purposes.

- **Requirement to File Estate Tax Return**. Generally, the executor of the deceased spouse's estate may only make the QTIP election on a timely filed federal estate tax return, which entails time and expense.

E. <u>All Assets to Surviving Spouse Outright or Marital Trust, with Option to Disclaim into Family Trust</u>

One of the most common planning techniques for married clients who might have a taxable estate is to utilize a "Disclaimer Family Trust," rather than hardwiring the deceased spouse's remaining BEA into a traditional Family Trust. Put simply, the first spouse to die will leave substantially all of his or her assets to the surviving spouse outright or to a Marital Trust for the surviving spouse's benefit. The surviving spouse will then have nine months from the first spouse's date of death to disclaim some or all of the assets, causing such disclaimed assets to pass to a Disclaimer Family Trust that closely resembles a traditional Family Trust. Attached as <u>Exhibit 2</u> are sample disclaimer clauses to be included in a client's Will or revocable living trust.

1. Advantages

There are many advantages to disclaimer-based planning, outlined below:

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[35] *See* IRC § 2056(b)(7)(B)(ii)(II).

- **Same Advantages as Outright Gift or Marital Trust**. Depending on whether the upfront bequest is made to the surviving spouse outright or to a Marital Trust, such upfront bequest offers the same benefits described above. It is even possible for a surviving spouse to have a "double" disclaimer option where assets pass to the surviving spouse outright, or to a Marital Trust if the surviving spouse disclaims the outright gift, or to a Disclaimer Family Trust if the surviving spouse disclaims both the outright gift and his or her interest in the Marital Trust.

- **Maximum Flexibility to Reassess Situation at Death of First Spouse**. When a married couple who might have a taxable estate executes their core estate plan, it is impossible to know what the exact situation will be at the death of the first spouse, in spite of our best speculation. Disclaimer-based planning arguably offers the surviving spouse the best chance at reassessing the situation upon the first spouse's death. Depending on how the core estate plan is structured, the surviving spouse could elect to keep things simple and minimize potential income taxes by receiving assets outright, preserve the deceased spouse's GST Exemption and add creditor protection by retaining assets inside a Marital Trust, or minimize potential federal estate taxes and include other family members by disclaiming assets into a Disclaimer Family Trust. These options are not mutually exclusive, and the surviving spouse may elect to allocate a portion of the deceased spouse's assets among various vehicles through a disclaimer-based plan. This type of flexibility is paramount for married clients who might have a taxable estate.

2. Disadvantages

Disclaimer-based planning has a few potential disadvantages, summarized below:

- **Complexity**. Adding a disclaimer option to a core estate plan also adds a level of complexity to the plan itself. In addition to more complex drafting, the disclaimer itself must meet several requirements under both federal and state law.[36] Consequently, the surviving spouse must generally seek competent counsel following the death of the first spouse to help evaluate whether a disclaimer makes sense and to prepare the legal documentation required to evidence the disclaimer.

- **Surviving Spouse Must Disclaim Before Accepting the Assets**. Disclaimers are great in theory, but can often fail to produce the desired results in practice. The surviving spouse may not fully understand the disclaimer option and may not actually go through the effort required to properly disclaim assets, as described above. Moreover, for a disclaimer to be effective, the surviving spouse cannot first accept any benefits from the disclaimed property.[37] It is quite easy for a surviving spouse to accept property inadvertently upon the death of a first spouse, before realizing that such acceptance eliminates any disclaimer option. For example, a surviving spouse could receive property by right of survivorship or beneficiary designation, almost immediately upon the first spouse's death, in which case the surviving spouse would be unable to disclaim such assets into the Disclaimer Family Trust. Due to these practical difficulties, some practitioners still prefer to hardwire the funding of a Family Trust at the death of the first spouse, simply to maximize the chances of fully utilizing the deceased spouse's BEA.

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[36] *See* generally IRC § 2518; TEX. EST. CODE Ch. 240.

[37] *See* IRC § 2518.

- **No Powers of Appointment**. For a disclaimer to be effective, the surviving spouse cannot control the control the passage of the disclaimed assets.[38] Importantly, though, a surviving spouse may still be a beneficiary of the Disclaimer Family Trust and may still serve as trustee, provided that the surviving spouse's ability to make trust distributions is limited by an ascertainable standard.[39] This control restriction, however, generally prevents a surviving spouse from having the ability to appoint the assets of the Disclaimer Family Trust during lifetime or upon death.[40] As a result, a Disclaimer Family Trust may not be as flexible for the surviving spouse as a hardwired Family Trust or Marital Trust, because the surviving spouse cannot retain a power of appointment over the trust assets.

F. Lesser Known Alternatives

Although the core estate planning alternatives discussed above are the most popular structures for married clients who might have a taxable estate, advisors should be aware of several other alternatives that could be worthwhile in more limited circumstances.[41] These lesser known alternatives are described below, without a full discussion of their advantages and disadvantages given their rather limited utility.

1. Build Greater Flexibility into Family Trust Provisions

Practitioners who still prefer leaving the deceased spouse's remaining BEA to a traditional, hardwired Family Trust may consider creative provisions designed to add flexibility to an otherwise rigid structure. Many of these provisions are designed to facilitate an income tax basis adjustment upon the surviving spouse's death, even though the assets of the Family Trust would typically be excluded from the surviving spouse's taxable estate without further planning. In many cases, this involves giving the surviving spouse a testamentary general power of appointment (typically exercisable only in favor of creditors of the surviving spouse's estate) to trigger estate inclusion.

For example, an independent trustee could have the ability to make distributions for any purpose whatsoever, which could facilitate an outright distribution to the surviving spouse or other beneficiaries, or decanting to a new trust where the surviving spouse has a testamentary general power of appointment. Alternatively, some Family Trusts include a third-party powerholder or trust protector with the ability to grant the surviving spouse a testamentary general power of appointment at a later date. Similarly, the trust instrument could give the surviving spouse a formula-based testamentary general power of appointment where the surviving spouse may only appoint assets up to an amount that does not increase federal estate taxes. While practitioners routinely include formula-based powers of appointment for GST tax purposes, this is relatively untested in the estate tax context.

In addition to added complexity, these types of provisions may suffer from being "too cute" when more conservative alternatives are available, as further discussed above.

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38 *See* IRC § 2518(b)(4).

39 *See* IRC § 2518(b)(4)(A).

40 *See* Treas. Reg. 25.2518-2(e)(1)(i).

41 For a general discussion of some lesser known alternatives, see Mickey Davis, *Basis Adjustment Planning,* STATE BAR OF TEXAS 38TH ANN. ADV. EST. PL. & PROBATE COURSE, ch. 10 (2014).

2. Charitable-Based Formulas

Charitably inclined clients may have a fairly simple solution to eliminate all federal transfer tax no matter what the future holds. Upon the death of the surviving spouse (or upon the death of a single client), the client's core estate plan can provide that an amount equal to the client's remaining BEA (plus any unused BEA ported from the first spouse to die) passes to the client's family members or other individuals. The excess, if any, passes to charity in a manner that qualifies for the unlimited charitable deduction.

The obvious advantage to this approach is that no federal estate tax should be due so long as there is an unlimited charitable deduction. The disadvantage to this approach, however, is that it could cause unintended results. For instance, if a client does not have a taxable estate, then client's estate plan may not benefit charity at all, which could be inconsistent with the client's true objectives. By contrast, if the BEA is greatly reduced or the client's assets greatly appreciate, only a small portion of the client's estate could pass to non-charitable beneficiaries, which again could be inconsistent with the client's objectives. In either case, advisors should think through and attempt to address all of the possible outcomes before recommending a charitable-based formula, then follow up with the client as needed to ensure that the formula still effectuates the client's intent.

3. Clayton QTIP Trusts

Named after the Fifth Circuit case of *Clayton v. Commissioner*,[42] the so-called Clayton QTIP generally provides that all assets pass to a Marital Trust for the benefit of the surviving spouse. If the executor of the deceased spouse's estate makes the QTIP election, the assets stay inside the Marital Trust. If the executor decides not to make the QTIP election, the assets pass as specified in the trust instrument, typically to a Family Trust. A partial QTIP election, therefore, would cause assets to pass to both a Marital Trust and a Family Trust.

The Clayton QTIP offers much of the same flexibility as disclaimer-based planning because assets can pass to a Marital Trust and/or Family Trust at the first spouse's death based on circumstances that exist at the time. Because assets do not pass to the Family Trust by disclaimer, however, the surviving spouse may still retain lifetime and testamentary powers of appointment over the trust assets, which adds even greater flexibility to the core estate plan.

At first glance, Clayton QTIPs may seem like an ideal solution for married clients who might have a taxable estate. There is a major downside, however, that renders Clayton QTIPs fairly unattractive for most clients. Specifically, there is a risk that if the surviving spouse serves as executor of the deceased spouse's estate, the surviving spouse may make a taxable gift if he or she fails to make the QTIP election. This is based on the premise that failing to make the QTIP election would cause assets to pass from a Marital Trust where the surviving spouse must receive all income to a Family Trust where income distributions are typically discretionary among other family members.

Due to the taxable gift concern, most practitioners will not implement a Clayton QTIP unless a disinterested party is appointed as executor of the deceased spouse's estate. To save expense and preserve control, most married clients prefer for the surviving spouse to serve as executor of the deceased spouse's estate. Consequently, Clayton QTIPs have failed to gain much traction within the estate planning community.

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[42] Clayton v. Comm'r, 976 F.2d 1486 (5th Cir. 1992).

V. LIFETIME GIFTING FOR CLIENTS WHO MIGHT HAVE A TAXABLE ESTATE

After solidifying a client's core estate plan, some clients may also wish to make lifetime gifts, either for non-tax reasons or in an effort to minimize federal transfer taxes. The paragraphs below discuss preliminary gifting considerations in both situations, highlight the continued importance of gifts that do not consume a client's BEA, and review creative gifting strategies for clients who might have a taxable estate.

A. Preliminary Gifting Considerations

1. Non-Tax Reasons for Gifting

Tax planning is fun. It is so much fun, in fact, that advisors can sometimes get carried away with lifetime gifting strategies that may make sense from a tax perspective but do not make sense for the real person sitting across the table. It is important to remember, therefore, that at its core, lifetime gifting begins with a client's basic desire to benefit others. The key to all client relationships is trust, and when discussing a particular planning technique, it is vital for advisors to keep things practical while clearly communicating both the advantages and disadvantages of the technique.

With this goal in mind, advisors should assist taxpayers in identifying non-tax motivations for gifting, which all clients, regardless of their net worth, should be able to identify. Below is a non-exhaustive list of reasons a client may wish to make lifetime gifts:

- To satisfy a beneficiary's current health, educational, or other need;
- Beyond basic needs, to permit a beneficiary to enjoy assets or a certain lifestyle now, particularly while the client is alive and has a chance to enjoy the impact of the gift;
- To equalize prior or current gifts among family members;
- To forgive prior loans;
- To provide a beneficiary with an opportunity to learn how to manage finances;
- To help a beneficiary start a business or invest in an entrepreneurial endeavor;
- To supplement the income of a beneficiary who wishes to enter into a lower-paying, but socially impactful, profession;
- To help facilitate a beneficiary's charitable giving endeavors;
- To provide a beneficiary with access to capital without exposing the assets to the claims of the beneficiary's actual or potential creditors;
- To facilitate business succession planning and/or motivate younger family members to participate in a family business; and
- To provide the client with insight regarding how a beneficiary handles gifted assets.

There are, of course, many other reasons why a client may wish to make a gift to a family member, friend, or other individual.[43] Whatever the reason, it is important to keep the client's basic objectives in mind, and, in certain cases, not let the tax tail wag the gifting dog.

2. Tax-Motivated Gifts

Of course, lifetime gifts can also be advantageous from a tax perspective for many reasons, including:

- Making gifts that do not consume the client's gift tax exemption in order to reduce the value of the client's taxable estate;
- Making gifts that do not consume the client's GST Exemption in order to reduce the value of the client's taxable estate and reduce potential GST taxes;
- Shifting appreciating assets, at a lower gift tax cost, from the client's taxable estate, to an irrevocable trust that is excluded from the client's taxable estate;
- Transferring assets with a valuation discount, such as minority interests in a closely held business, to an irrevocable trust that is excluded from the client's taxable estate;
- Funding irrevocable grantor trusts to facilitate the client's payment of the trust's income tax liabilities, which is not treated by the IRS as an additional gift;[44]
- Taking advantage of certain irrevocable trusts authorized by statute, such as GRATs and qualified personal residence trusts ("QPRTs"), to shift appreciating assets to lower generations at a reduced transfer tax cost; and
- In rare circumstances, gifting an asset and paying out-of-pocket gift tax, which is calculated on a tax-exclusive basis, rather than retaining the asset in the client's taxable estate and paying estate tax, which is calculated on a tax-inclusive basis.

There are certainly more reasons why a client may be motivated by transfer tax reasons to make lifetime gifts. Specific lifetime gifting strategies are further analyzed below.

3. Preliminary Gifting Considerations

Once a client communicates his or her desire to make a lifetime gift, the next step is to confirm that the gift is appropriate and, if so, to help structure the gift to achieve the client's tax and non-tax objectives. Below is a non-exhaustive list of preliminary considerations when structuring a client's lifetime gift:[45]

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[43] For a great discussion of non-tax reasons for gifting, as well as other lifetime gifting considerations, see Ann B. Burns, *They Say You Can't Take it With You – But How Do You Give It Away? Using the $5 Million Exclusion Amount*, 46TH ANNUAL HECKERLING INSTITUTE (Jan. 2012).

[44] *See* Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

[45] For additional gifting considerations, see Ann B. Burns, *They Say You Can't Take it With You – But How Do You Give It Away? Using the $5 Million Exclusion Amount*, 46TH ANNUAL HECKERLING INSTITUTE (Jan. 2012).

- The client's financial needs, including the client's living expenses and required cash flows;
- The client's desire, if any, to maintain control over the gifted asset;
- The client's desire to protect the transferred assets from the donee's creditors, divorcing spouses, or even the donee's own spending habits and other vices;
- The client's ability to handle complexity or, in contrast, the client's desire to keep things simple;
- The client's risk tolerance, particularly if the gifting strategy involves a more aggressive strategy designed to maintain more control and access than an outright gift;
- The client's willingness to adhere to best practices to reduce tax and creditor risk;
- The client's budget for legal, accounting, appraisal, and other professional fees;
- The donee's age and station in life;
- The donee's family and financial circumstances;
- The donee's ability to handle complexity; and
- The assets available to gift, including each asset's fair market value, income tax basis, appreciation potential, and administrative ease.

Several of these preliminary considerations merit further discussion.

a. Client's Financial Circumstances

Before advising any client to make a lifetime gift, the client should confirm that, after the gift is made, the client will retain sufficient resources to provide for his or her needs, both now and in the future. This analysis will certainly be unique for each client, and generally should include the client's financial and investment advisors. In addition to reviewing the assets and income streams to be retained by the client, the client's lifestyle should also be closely examined, including the client's spending habits, desire for future gifts, potential health care costs, and other appropriate factors. This analysis is particularly important for clients who are primarily motivated by potential transfer tax savings because they might have a taxable estate, but who may also need access to funds to support their lifestyle. Super generous (but not super wealthy) clients should be advised to remember their own needs, in addition to those of their desired beneficiaries.

b. Client's Family Dynamics

It is also important to understand and consider the client's family dynamics. This goal can be difficult at times, but clients should be pressed to ensure that they are being honest, even with themselves. For example, would substantial gifts to the donee incentivize or disincentivize the donee to be a productive member of society? (Is such a goal important to the client?) Is the donee financially responsible, or would this gift contribute to the donee's already poor financial decisionmaking? Does the donee have substance abuse issues or other addictive tendencies? How strong is the donee's marriage?

These can be difficult questions, but the better clients know themselves and their goals, the better we can assist in planning to help clients accomplish those goals.

c. Asset Selection

Some assets are better to transfer than others, and asset selection is a key element in designing an effective gifting strategy. As a general rule, particularly when gifts are motivated by tax reasons, clients should seek to give assets with high appreciation potential, as removing future appreciation from the client's taxable estate could result in significant transfer tax savings for the client's family. Clients should be reminded, however, that not every asset appreciates, and if an asset depreciates after a gift is made, the client's BEA could be wasted or, in the case of an installment sale transaction, the transaction could unintentionally result in a "reverse" wealth shift. With a reverse wealth shift, a client is often worse off, from a transfer tax perspective, than if the client had not made the gift at all.

Clients should also consider how an asset's income tax basis impacts its suitability for gifting. Because most gifted assets will have a carryover income tax basis, it is usually better to gift high basis assets. Low basis assets should typically be retained by the client to be distributed through the client's taxable estate to obtain the basis step-up at the client's death. Moreover, it is important to recognize that some assets, like a family farm, may never be sold, in which case a low carry-over income tax basis should not be a significant deterrent to making a gift. Income tax basis planning is further discussed in Part II.B above.

Finally, clients should consider how easy (or difficult) it is to gift certain assets. For example, depending on the client's objectives, it may be more appropriate to gift separate property instead of community property, or vice versa. Some intangibles, such as cash, marketable securities, or public stock, are easy to value, easy to give, and easy to receive. Other intangibles, such as closely held business interests, are often more difficult to value, give and receive, but may offer greater appreciation potential as a result of valuation discounts at the time of the gift. The same may be true for real property and high dollar tangibles, such as collectibles or jewelry. In any case, before making a gift, the client should consider how difficulties in valuing, transferring, and administering the gifted property may impact the client's overall objectives.

d. Making Gifts Outright or in Trust

There are two basic ways to make a gift—outright or in trust. The biggest advantage to an outright gift is simplicity. To effectuate the gift, the client can simply execute any necessary paperwork to transfer the property and, if required, report the gift. At that point, the client should be finished and there should be no further administration or related costs. With an outright gift, however, the client may lose control of the gifted asset and will forfeit the opportunity to provide the donee with added creditor protection and estate tax savings.

Rather than making an outright gift, the client can transfer the property to an irrevocable trust for the benefit of the donee. Clients desiring to retain some level of control over the gifted assets may even serve as trustee of the irrevocable trust, provided the trust agreement is carefully drafted to ensure that the trustee's powers do not cause inclusion of the trust assets in the client's taxable estate. For example, the client's ability to make distributions should be limited to an ascertainable standard related to the beneficiary's health, education, maintenance, and support.[46] Moreover, a properly structured trust could provide the donee with creditor and divorce protection, and in certain cases, preserve the donee's eligibility for federal and state governmental benefits. An irrevocable trust may also serve to remove the

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[46] *See* IRC § 2514(c)(1).

trust property (plus all future appreciation) from both the donor's and the donee's taxable estates. If the trust is structured as a grantor trust, the client will pay the income tax attributable the trust's income without such payments being treated as additional gifts and allowing the trust asset to appreciate more rapidly.

On the other hand, creating and administering an irrevocable trust may increase transaction costs and add complexity, compared to an outright gift. Many clients may not have the appetite for this added complexity, and sometimes the value of the gifted property does not justify the added expense. From an income tax perspective, if the trust is a non-grantor trust, the trust will be subject to the highest income tax bracket at a much lower amount of income compared to an individual.

Whether to make a gift outright or in trust is ultimately the client's decision and should reflect the client's objectives. In certain cases, such as with a minor or disabled beneficiary, the decision to utilize a trust should be relatively straightforward. In other cases, such as with a moderately valued gift to a responsible adult beneficiary, the analysis may be more difficult. Again, the more advisors know about their clients, including their clients' assets and family dynamics, the better the advisor's recommendations will be. Asking tough questions and making the effort to know a client's business and family are cornerstones of designing a suitable gifting strategy.

B. Taking Advantage of the "Freebies:" Gifts That Do Not Consume BEA

To optimize a client's lifetime gifting strategy, it is important to understand the "freebies," or gifts that do not consume a client's gift tax exemption. Mastery of these rules is important when planning for all clients, regardless of their net worth. For clients who already have a taxable estate, or may have a taxable estate in the future, taking advantage of the freebies helps preserve the client's BEA and GST Exemption for more substantial transfers, either during lifetime or upon death. For clients who are unlikely to ever have a taxable estate, taking advantage of the freebies may simplify gifting by eliminating the need to prepare and file annual gift tax returns. The paragraphs below discuss the most popular freebies, including transfers that qualify for the unlimited marital and charitable deductions, qualified transfers for medical and educational purposes, and annual exclusion transfers.

1. Marital and Charitable Deduction

A taxpayer's gifts during life or bequests at death to a U.S. citizen spouse (or certain marital trusts) receive an unlimited marital deduction from federal gift and estate taxes and do not consume a taxpayer's BEA.[47] Similarly, gifts during life or bequests at death to a qualified charity (or certain charitable trusts) receive an unlimited charitable deduction.[48] Part V.C.2 discusses several strategies that make creative use of the marital deduction to facilitate lifetime gifts.

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[47] *See* IRC § 2056 and accompanying Treasury Regulations. IRC § 2516 also provides that, subject to certain exceptions, transfers made between spouses pursuant to a divorce settlement agreement shall not consume either spouse's BEA.

[48] *See* IRC § 2055 and accompanying Treasury Regulations.

2. Health and Education Exclusion

a. In General

Certain "qualified transfers" are not treated as transfers for tax purposes. Therefore, they do not consume BEA or GST Exemption, regardless of the donee or amount of the transfer.[49] Code § 2503(e)(2) defines qualified transfers as any amount paid on behalf of an individual:

(i) as tuition to an educational organization described in Code § 170(b)(1)(A)(ii) for the education or training of such individual; or

(ii) to any person who provides medical care, as defined in Code § 213(d), with respect to such individual as payment for such medical care.

In other words, a client may make unlimited direct payments of qualified health and education expenses (the "Health and Education Exclusion") on behalf of any number of persons, including "skip persons" for GST purposes, without utilizing any portion of the taxpayer's BEA, GST Exemption, or annual exclusion. This powerful planning tool should not be overlooked when advising clients. For example, a wealthy grandparent could fund all of his or her family member's educations and provide for all of their medical needs. Not only do these payments benefit the grandparent's family members, they also remove the gifted assets from the grandparent's taxable estate, which should reduce the estate and GST tax burden upon the grandparent's death.

b. Limitations

While very valuable, transfers intended to qualify for the Health and Education Exclusion under Code § 2503(e)[50] must meet several requirements. First, the payment must be made directly to the medical service provider or educational institution. Payments made directly to an individual, who then utilizes the payment to cover medical or education costs, do not qualify for the Health and Education Exclusion. Similarly, contributions to a 529 plan, as described in Part V.B.5.b(2), are not treated as qualified transfers.

Second, if the payment of a medical expense is reimbursed by insurance, it does not qualify for the Health and Education Exclusion.

Third, the Health and Education Exclusion only applies to "qualified transfers." For health care expenses, qualified transfers only include payments made to prevent or treat a physical or mental defect or illness, and do not include payments for cosmetic or elective treatments. While the payment of a person's insurance premiums, hospital services, dental care, nursing care, and medications should be considered qualified transfers, elective surgeries and other non-essential medical care should not. For education expenses, qualified transfers only include tuition paid to educational institutions. Although schools at any level and location may qualify as an educational institution, payments for room and board, books, and other supplies are generally not considered qualified transfers. Whether a particular payment is a qualified transfer depends on the unique facts and circumstances surrounding the payment. Thus, it is important that clients consult with legal counsel or an accountant prior to making a payment to determine whether such payment would be considered a qualified transfer.

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[49] *See* IRC § 2503(e)(1); IRC § 2611(b)(1).

[50] For an excellent discussion of the Health and Education Exclusion, including specific examples of qualified transfers, see Susan Bart, David Pratt, & Lauren Wolven, *ANTI-Trust Planning: Competition for Trusts*, 45TH ANNUAL HECKERLING INSTITUTE (2011).

c. Health and Education Exclusion Trusts

It is fairly easy for a wealthy grandparent, during his or her lifetime, to fund the health care and education expenses of grandchildren. As discussed above, the grandparent can simply make direct payments to health care providers and educational institutions, which should be free of gift and GST tax. Clients who wish to continue funding health and education expenses for future generations after their deaths in a tax-efficient manner may consider creating a health and education exclusion trust ("HEET").[51]

A HEET is an irrevocable trust created during lifetime or at death that substantially benefits charity while providing a source of payment for the health and education needs of individual beneficiaries free of GST tax. Transfers to a HEET will not qualify for an estate or gift tax charitable deduction, but should not consume GST Exemption because charity's interest should prevent the HEET from being considered a skip person. Further, distributions from the HEET for the benefit of skip persons should not be subject to GST tax because such distributions must meet the requirements of the Health and Education Exclusion.

Although a HEET can preserve substantial assets for the health care and education needs of future generations, while also facilitating a taxpayer's charitable objectives, there are several potential disadvantages to HEETs. First, transfers to a HEET are not the most transfer tax-efficient method of providing for charity because the charity's interest in the HEET will not qualify for the transfer tax charitable deduction. One potential workaround is for the client to form a HEET to receive the remainder interest upon termination of a GRAT. A GRAT is generally considered to be a poor multi-generational planning vehicle because the donor cannot allocate GST Exemption until the close of the estate tax inclusion period (*i.e.*, the termination of the GRAT). However, because a HEET is not a skip person, the client does not need to allocate GST Exemption, which can make the combined use of a GRAT and HEET particularly tax-efficient. These tax efficiencies are enhanced because distributions from the HEET to charity qualify for the income tax charitable deduction.[52]

Second, the HEET must be carefully drafted. Not only must charity have a "significant" beneficial interest, which can be difficult to define, the HEET must avoid creating two separate shares for GST purposes—one for charity and one for individual beneficiaries.

Third, HEETs have been targeted by the Department of Treasury, which has recommended that only payments from an individual (and not a trust) to a medical service provider or educational institution qualify for the Health and Education Exclusion.[53] If Congress adopted Treasury's proposal, it would effectively eliminate HEETs.

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51 For further reading on HEETs, see Wendy Goffe, *An Introduction to Lesser Known but Useful Trusts*, LEIMBERG INFORMATION SERVICES, INC., Estate Planning Newsletter #1764 (Jan. 19, 2011).

52 The charitable income tax deduction is taken by the grantor if the HEET is structured as a grantor trust or by the HEET itself if it is structured as a non-grantor trust.

53 In their General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals (commonly called the "Greenbook"), Treasury recommended an amendment to IRC § 2611(b) to provide that only payments from an individual to a medical service provider or educational institution would qualify for the Health and Education Exclusion. Distributions from a trust, including a HEET, would not qualify for the Health and Education Exclusion. The proposal, however, was designed to apply only to trusts created after the introduction of the bill proposing this change, as well as to transfers after such date to pre-existing trusts. Thus, transfers to and from pre-existing HEETs should be grandfathered and not subject to GST tax.

3. Annual Gift Exclusion

a. In General

Code § 2503(b)(1) provides that a donor may make annual gifts of up to $10,000 per donee without utilizing any portion of the taxpayer's BEA (the "Annual Gift Exclusion"). Code § 2503(b)(2) indexes the Annual Gift Exclusion for inflation. In 2022, the Annual Gift Exclusion is $16,000 per donor, per donee. In other words, a donor may give as much as $16,000 in 2022 to as many individuals as the donor likes without gift tax consequences. If the donor is married and the donor's spouse consents to split the gift under Code § 2513, or if the gift is of community property, the donor (and the donor's spouse) may give as much as $32,000 in 2022, per donee, using the Annual Gift Exclusion.

b. Limitations

When used systematically, gifts that qualify for the Annual Gift Exclusion can be a powerful tool to transfer substantial amounts of wealth over a period of years, especially for a large family with many beneficiaries. There are, however, several traps for the unwary.

First, a gift will qualify for the Annual Gift Exclusion, only if the donee receives a "present interest" in the gifted property. Treasury Regulation § 25.2503-3(b) defines a present interest as an "unrestricted right to the immediate use, possession, or enjoyment of property." So-called "future interests" in property, which Treasury Regulation § 25.2503-3(a) defines as interests "limited to commence in use, possession, or enjoyment at some future date or time," do not qualify for the Annual Gift Exclusion. How to ensure that certain gifts, including gifts to trusts, qualify for the Annual Gift Exclusion is further discussed in Part V.B.5.

Second, clients should avoid being too aggressive in attempting to multiply the number of donees whose interest in the gifted property may be illusory. The IRS has denied the Annual Gift Exclusion for a number of unconventional (and in the Service's view, abusive) gift transactions.[54] In this regard, it is important to recognize that the Annual Gift Exclusion is largely a matter of administrative convenience for the Service, which recognizes that taxpayers often make gifts to friends and family members in the form of birthday and holiday gifts, meals, clothing, or transportation expenses. For the most part, these small gifts would be too administratively difficult to track and report. If a client gifts property to each of her children in an amount equal to the full Annual Gift Exclusion on January 1st, should everyday gifts made later in that year be reported and consume the client's BEA? In the Service's view, the answer is yes. To avoid any such issues, it may be prudent for a client to give property with a value somewhat less than the Annual Gift Exclusion each year (*e.g.*, $14,000 of the $16,000 available in 2022), to save Annual Gift Exclusion for all of the "extra gifts" that may be made throughout the year.[55]

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[54] *See, e.g.*, Heyen v. United States, 945 F.2d 359 (10th Cir. 1991) (Annual Gift Exclusion denied for gifts of stock to 27 unrelated individuals who immediately re-gifted the stock to members of the decedent's family); Estate of Bies v. Comm'r, T.C. Memo. 2000-338 (Nov. 2, 2000) (Annual Gift Exclusion denied for gifts of stock to spouses of donor's children who immediately re-gifted the stock to donor's children); Sather v. Comm'r, T.C. Memo. 1999-309 (Sept. 17, 1999) (Annual Gift Exclusion denied for reciprocal gifts by siblings to each other's children); Estate of Cidulka v. Comm'r, T.C. Memo. 1996-149 (Mar. 25, 1996) (Annual Gift Exclusion denied for gifts to daughter-in-law and grandchildren who immediately re-gifted assets to donor's son).

[55] Weddings provide an interesting case study for the Annual Gift Exclusion, particularly when wealthy parents choose to foot the bill for the couple. On the one hand, many weddings far exceed the Annual Gift Exclusion available that would typically be available to make gifts to the couple. On the other hand, there could be a large number of wedding guests, and it is arguable that the wedding benefits the parents and the guests, and not just the marrying couple.

4. Annual GST Exclusion

Similar to the Annual Gift Exclusion, Code § 2642(c), enables a donor to give up to $16,000 of property per year to as many skip persons (*i.e.*, persons two or more generations below the donor) as the donor likes without paying GST tax or utilizing any portion of the donor's GST Exemption (the "Annual GST Exclusion"). For example, if a grandparent gives $16,000 cash to a grandchild in 2022, the gift should qualify for both the Annual Gift Exclusion and the Annual GST Exclusion (together, the "Annual Exclusions"). There are, however, special requirements for transfers in trust to qualify for the Annual GST Exclusion, which are further discussed in Part V.B.5.c.

5. Using the Annual Exclusions

a. Outright Gifts

The simplest way for a client to take advantage of the Annual Exclusions is to make outright gifts of easy-to-value assets, such as cash or marketable securities, directly to an individual. Clients may also utilize the Annual Exclusions by forgiving a debt, paying an obligation on behalf of a beneficiary, or allowing a beneficiary to live in a residence rent-free. For example, if a son had previously borrowed money from his parents with interest at the applicable federal rate, in 2022 the parents could forgive up to $32,000 of interest and principal under the Annual Gift Exclusion, assuming it was a bona fide loan at the outset. Alternatively, the parents could pay up to $32,000 of their son's mortgage for the year or permit their son to live in a home owned by the parents so long as the fair market rent for the home did not exceed $32,000 per year.

Clients who regularly make gifts to fully utilize their Annual Exclusions, should facilitate continued gifts in the event of their incapacity. This may be accomplished by the client signing (i) a durable power of attorney that specifically authorizes an agent to make annual exclusion gifts or (ii) a funded revocable trust that specifically authorizes the trustee to make annual exclusion gifts.

b. Gifts for the Benefit of Beneficiaries, but not in Trust

Many clients who make annual exclusion gifts desire to retain control of the gifted assets and minimize complexity and costs. These clients often resist using an irrevocable trust, instead gifting assets to a Uniform Transfers to Minors Act ("UTMA") account, Code § 529 plan, or, for disabled beneficiaries, an Achieving a Better Life Experience Act ("ABLE") account, each of which is briefly discussed below.[56]

(1) UTMA Accounts

Most states have legislation authorizing the creation of UTMA accounts. An UTMA account involves three parties—a donor, custodian, and beneficiary. The UTMA account can only have one current beneficiary, but it can receive contributions from multiple donors. The custodian has a duty to invest and distribute funds for the beneficiary, with broad discretion regarding the timing and manner of distributions. While there is variation among states, the UTMA account assets must usually be distributed to the beneficiary when the beneficiary reaches age 21. If the beneficiary dies before reaching age 21, the UTMA account assets will be distributed to the beneficiary's estate.

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[56] For a more thorough discussion of UTMA Accounts, 529 plans, and all things in between, see Susan Bart, David Pratt, & Lauren Wolven, *ANTI-Trust Planning: Competition for Trusts*, 45TH ANNUAL HECKERLING INSTITUTE (2011).

Often, a client funding the UTMA account desires to control investments and distributions by serving as custodian. Because the statutory powers of the custodian are so broad, however, the client should be aware that serving as custodian of assets contributed the UTMA account could cause unexpected adverse tax consequences. For example, if the client serves as custodian, the property gifted by the client to the UTMA account could be incomplete due to the client's broad discretion to make distributions or the ability of the client to utilize the UTMA account assets to satisfy his or her obligation of support. In addition, the UTMA account assets could be includible in the client's gross estate if he or she dies before the beneficiary reaches age 21 and the UTMA account terminates.[57] Finally, there may be issues in qualifying gifts to an UTMA account for the Annual Gift or GST Exclusions depending on when the UTMA account terminates.[58]

The client can avoid these potential tax issues by designating a third party as custodian. However, the client must weigh any potential tax certainty against the client's loss of control over the UTMA account. Many clients are willing to assume the tax risks in order to serve as custodian and retain control.

(2) 529 Plans

Code § 529 plans refer to state-sponsored qualified tuition programs. Clients typically contribute cash to 529 accounts to provide for the education of a child, grandchild, or other beneficiary. The client can retain broad control over investments in and distributions from the 529 account. As long as distributions are made for qualified higher education expenses at an eligible institution, earnings in the 529 account are not subject to federal income tax. If a distribution is not used for qualified higher education expenses, the distribution will be subject to income tax and a 10% penalty.[59]

In addition to controlling investments and distributions the client can change the beneficiary of the 529 account. If a client's child, for example, does not pursue a college education, the client can designate another child as beneficiary of the 529 account. Further, while the Health and Education Exclusion only permits tax-advantaged payments of tuition directly to the educational institution, 529 accounts can be utilized for much broader purposes, including room and board, meals, and books.

Unlike any other completed gift transfer, the client can reacquire the 529 account assets, albeit subject to potential income tax and a penalty, as discussed above. Despite the client's control and access, 529 account assets are generally protected from creditors, not included in financial aid calculations for the beneficiary, and not included in the client's taxable estate. While investment options for 529 account assets may be somewhat limited, the flexibility, tax efficiency and low-costs associated with a 529 account make them very attractive to clients.

From a transfer tax perspective, contributions to a 529 account should qualify for both the Annual Gift Exclusion and the Annual GST Exclusion. The client can also "front-load" contributions to a 529 account by contributing up to five times the annual exclusion amount (currently $80,000 per donor, per donee, or $160,000 per married couple) without utilizing any BEA.[60] The client must make the five-year election on a gift tax return, and must prorate the 529 contribution equally over a five-year period. If the

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57 *See* IRC § 2038; Rev. Rul. 57-366, 1957-2 C.B. 618; *see also* IRC § 2036(a) (potentially applicable if the custodian has a legal obligation to support the beneficiary).

58 *See* IRC § 2503(c); IRC § 2642(c)(3).

59 *See* IRC § 529(c)(6); IRC § 530(d)(4).

60 *See* IRC § 529(c)(2)(A)(i).

client dies prior to the beginning of the fifth year, the portion allocated to future years is included in the client's taxable estate.[61] Otherwise, 529 accounts are generally excluded from the client's estate.[62]

(3) ABLE Accounts

ABLE accounts were authorized in 2014 under Code § 529A to provide donors with a state-sponsored, tax-advantaged savings accounts for disabled beneficiaries. An individual is an eligible beneficiary of an ABLE account if, during the taxable year, the individual is entitled to Social Security benefits based on a disability that occurred before the individual reached age 26.[63] Most qualified distributions from an ABLE account should not impact the beneficiary's eligibility for governmental benefits, and earnings inside the ABLE account should be exempt from income tax.[64]

Similar to a 529 account, contributions to an ABLE account should qualify for both the Annual Gift Exclusion and Annual GST Exclusion. ABLE accounts, however, are not as flexible as 529 accounts. A beneficiary may only have one ABLE account for his or her benefit (regardless of the number of donors), and donors may only contribute cash to this single ABLE account.[65] There are also strict limitations, depending on governing state law, on the annual amount of contributions to and total amount of the ABLE account. Finally, ABLE accounts are generally subject to claims for Medicaid payments made by the relevant state.[66]

Due to these disadvantages, clients may prefer to utilize a special needs trust to make annual exclusion gifts for the benefit of a beneficiary. In general, a special needs trust is an irrevocable trust that provides the trustee with absolute discretion to make distributions for a disabled beneficiary, without causing the trust assets to be included as part of the beneficiary's resources in determining eligibility for governmental benefits. Not only can the client contribute substantial funds to a special needs trust over time, such a trust is not restricted by contribution limits, asset limits, or state Medicaid payback provisions.[67]

c. Gifts to Trusts

As discussed above, the Annual Exclusions are only available for gifts of property in which the beneficiary has a present interest to enjoy, such as an outright gift of property. A beneficiary's interest in property transferred to an irrevocable trust is typically a future interest that does not qualify for the Annual Exclusions. There are, however, exceptions to this general rule, discussed below.

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61 *See* IRC § 529(c)(4)(C); Prop. Treas. Reg. § 1.529-5(d)(2).

62 *See* IRC § 529(c)(4)(A).

63 *See* IRC § 529A(e)(1).

64 *See* IRC § 529A(a).

65 *See* IRC § 529A(b)(2).

66 For a broad overview of estate planning considerations for ABLE accounts, see Philip Herzberg, *ABLE Act Considerations for Estate Planning*, JOURNAL OF FINANCIAL PLANNING, Aug. 2015, available at https://www.onefpa.org/journal/pages/aug15-able-act-considerations-for-estate-planning.aspx.

67 For an overview of special needs planning, see Bernard A. Krooks, *Special Needs – Special Planning: What You Don't Know Can Hurt You and Your Client!*, 50TH ANNUAL HECKERLING INSTITUTE (Jan. 2016).

(1) 2503(c) Trusts for Minors (under Age 21)

Code § 2503(c) provides that a gift to a trust for the benefit of a beneficiary who is under the age of 21 shall be treated as a gift of a present interest, and therefore qualify for the Annual Gift Exclusion, as long as:

(i) the trustee has broad discretion to make distributions of income and principal to the beneficiary before the beneficiary reaches age 21;

(ii) the beneficiary is entitled to withdraw all of the trust property at age 21; and

(iii) if the beneficiary dies before reaching age 21, the trust assets are included in the beneficiary's estate.

Although a client may transfer any type of property to a 2503(c) trust, the statutory requirements and tax aspects of 2503(c) trusts limit their use. Not only must the trust assets be used for only one beneficiary, but also the beneficiary must be entitled to withdraw the entire trust property at age 21, which requirement is often contrary to the client's wishes in funding a trust. In addition, because the Treasury Regulations require that the trustee of a 2503(c) trust be able to make distributions without "substantial restrictions," a donor should refrain from serving as trustee of a 2503(c) trust if the donor wishes to avoid inclusion of the trust assets in the donor's estate.[68]

(2) Crummey Trusts

i. In General

A "Crummey" trust, which takes its name from the historic *Crummey* case,[69] is an alternative technique that clients can use to take advantage of the Annual Exclusions when transferring property to a beneficiary, while enabling the client to impose restrictions on when the beneficiary can access the gifted property.

A Crummey trust permits a trust beneficiary to withdraw the donor's contribution for a short period of time, such as 30 days after the transfer. If the beneficiary does not withdraw the contribution within that time period, all or a portion of the withdrawal right will lapse and the property is retained in trust, subject to the terms of the trust agreement, the tax consequences of which are discussed in Part V.B.5.c(2)ii. For example, the Crummey Trust can provide that the beneficiary can only withdraw one-half of the trust assets at age 25 and the balance of the trust assets at age 30. The withdrawal right should cause the beneficiary to have a "present interest" in the donor's gift to the trust that qualifies the gift for the Annual Gift Exclusion. Note, however, that a Crummey Trust may be structured to qualify gifts for the Annual Gift Exclusion, but such gifts may not always qualify for the Annual GST Exclusion, as further discussed below.

ii. Advantages to a Crummey Trust

One advantage to a Crummey trust, compared to a 2503(c) trust, a 2642(c) trust (discussed below), or an UTMA account, is that a Crummey trust can benefit more than a single beneficiary.

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68 *See* Reg. § 25.2503-4(b); *see also* Louis S. Harrison, *Structuring Trusts to Permit the Donor to Act as Trustee*, ESTATE PLANNING (Nov./Dec. 1995) (discussing how an ascertainable standard could be deemed a substantial restriction for purposes of IRC § 2503(c)).

69 *See* Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968).

Irrevocable life insurance trusts, or "ILITs," are very often structured to provide multiple beneficiaries with Crummey withdrawal rights that enable the donor to utilize multiple Annual Gift Exclusions to facilitate payment of higher annual policy premiums. And in contrast to 2503(c) trusts and UTMA accounts, Crummey Trusts are not required to grant a beneficiary the right to withdraw assets upon a beneficiary attaining a certain age. Rather, the Crummey Trust assets can be retained in trust throughout the beneficiary's lifetime. Despite these advantages, several issues can arise in the design and administration of Crummey Trusts, as outlined below.

iii. Lapsing Withdrawal Rights

A beneficiary, who fails to exercise a withdrawal right with respect to a trust contribution and allows the withdrawal right to lapse, may be deemed to have made a taxable gift. A Crummey trust will often grant each beneficiary a withdrawal power equal to the full Annual Gift Exclusion, reduced by the value of all previous present interest gifts to or for the benefit of the beneficiary by the same donor during the same calendar year. If the beneficiary releases or allows the withdrawal right to lapse, the beneficiary may be considered to have made a transfer to the trust because the release or lapse of a withdrawal right is considered a release of a general power of appointment. However, Code § 2514(e), provides that the lapse of a beneficiary's withdrawal right will be considered a transfer to the trust only to the extent the lapsed withdrawal right exceeds the greater of $5,000 or 5% of the total value of the trust.

There are three approaches to prevent a beneficiary from making a current taxable transfer upon the lapse or release of a withdrawal right.

First, some trust agreements simply limit the beneficiary's withdrawal rights over property contributed to the trust to the <u>lesser</u> of (i) the full Annual Gift Exclusion or (ii) the greater of $5,000 or 5% of the aggregate value of the assets subject to the withdrawal power. While this structure limits gift tax free transfers to a trust in an amount equal to the greater of $5,000 or 5% of trust assets, it may be appropriate for a client who intends to make annual trust contributions of $5,000 or less per beneficiary.

Second, the trust agreement can prevent the beneficiary from making a current taxable gift upon the lapse or release of the withdrawal right if the trust agreement grants the beneficiary a continuing limited power of appointment over the portion of the contributed assets that would be otherwise considered a gift by the beneficiary, thus resulting in an incomplete gift. Ultimately, the lapse of the withdrawal right will be a completed transfer at the beneficiary's death, at which time a portion of the trust will be included in the beneficiary's estate.

Third, the trust agreement can grant the beneficiary a withdrawal right over property contributed to the trust in an amount equal to the full Annual Gift Exclusion (again reduced by prior present interest gifts during the same year to the same beneficiary by the same donor), while also providing that the beneficiary's withdrawal right lapses only to the extent of the $5,000 or 5% limitation. In such case, the beneficiary will retain the withdrawal right over the excess contribution until such "hanging" withdrawal right can lapse in subsequent years, perhaps when additional gifts are not made to the trust or when the trust principal has substantially increased. While this structure may prevent the beneficiary from making a current gift with respect to a portion of each contribution to the trust, upon the beneficiary's death, the beneficiary's gross estate will include a portion of the trust's assets based on the amount of any hanging withdrawal rights.

iv. Existing Trusts without Appropriate Crummey Withdrawal Rights

At times, a client may wish to make contributions to an existing irrevocable trust that does not include "appropriate" withdrawal rights (*i.e.*, the trust agreement contains no withdrawal rights, limits withdrawal rights to $5,000, or grants withdrawal rights that are too extensive). While the client typically cannot amend the trust agreement to alter (or include) the withdrawal rights, the client can overrule the trust agreement's withdrawal right provisions in a Deed of Gift that sets out new withdrawal rights as a condition to the gift to the trust. The trustee would then provide the beneficiaries with a letter informing them of the contribution and the applicable withdrawal rights. Examples of a Deed of Gift and a Withdrawal Notice Letter that create hanging withdrawal rights in a trust are included as Exhibit 3 and Exhibit 4.

(3) Requirements for Transfers in Trust to Qualify for Annual GST Exclusion

An outright gift to a skip person (*e.g.*, a grandchild) may easily qualify for the Annual Exclusions. However, Code § 2642(c)(2) provides that a transfer of property to a trust for the benefit of a skip person will qualify for the Annual GST Exclusion only if the trust agreement satisfies two additional requirements:

(i) during the life of the beneficiary, no trust assets may be distributed to any other person; and

(ii) if the trust does not terminate before the beneficiary dies, the trust assets are included in the beneficiary's estate.

In other words, a 2642(c) trust can only benefit one individual, and all of the trust assets must be included in the beneficiary's taxable estate. A contribution to a trust that fails to satisfy one or both of these requirements may still qualify for the Annual Gift Tax Exclusion, while needlessly wasting GST Exemption.

(4) Gifts of Closely Held Business Interests

Annual exclusion gifts of closely held business interests, such as limited partnership ("LP") or limited liability company ("LLC") interests, can be a very effective estate planning tool for clients with large families. A gift of an entity interest, however, may not always qualify for the Annual Gift Exclusion. Code § 2503(b) provides that the Annual Gift Exclusion applies only to gifts of a "present interest," which are specifically those gifts that are "other than gifts of [a] future interest in property." A gift of an interest in property qualifies as a present interest only if the gift meets one of two prongs, referred to as the "Property Prong" and the "Income Prong" of the present interest test.

To meet the Property Prong, the donee must have an "unrestricted and noncontingent right to the immediate use, possession, or enjoyment of [gifted] property."[70] And to meet the Income Prong, the donee must have an "unrestricted and noncontingent right to the immediate use, possession, or enjoyment of the income from the [gifted] property."[71]

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[70] *See* Hackl v. Comm'r, 118 T.C. 279 (2002), *aff'd* 335 F.3d 664 (7th Cir. 2003).

[71] *See id.*

For example, if a limited partner has no voting rights and has no right to transfer a gifted entity interest, the Service may determine that the gift of such an interest is not a present interest.[72] On the other hand, if a limited partner has the right to transfer the interest, even if subject to the approval of other owners, or the right to receive income distributions, a gift of such an interest should be considered a gift of a present interest that qualifies for the Annual Gift Exclusion.[73]

Consider one or more of the following provisions when seeking to qualify gifts of entity interests for the Annual Gift Exclusion:

- Limit others' control over the donee's enjoyment or use of the gifted entity interest;[74]
- Confirm that (i) the entity will generate income, (ii) some portion of that income will flow steadily to the donee, and (iii) the portion of income flowing to the donee can be readily ascertained;[75]
- Allow transfers of entity interests to permitted transferees, such as existing partners, members, or family members;
- Give the donee the right to compel the entity to redeem the donee's interest for an amount equal to its fair market value; or
- Gift the entity interest to a Crummey Trust and have the donor transfer, pledge, or loan other property to the trust that can be used to satisfy the transferee's withdrawal right.

C. Creative Gifting Strategies for Clients Who Might Have a Taxable Estate

After confirming a client's non-tax objectives and, if applicable, making lifetime transfers that do not consume gift tax exemption, it may be appropriate for some clients to make more substantial gifts that do consume gift tax exemption. Gifting strategies for clients who might have a taxable estate should strike the right balance between minimizing transfer taxes and preserving sufficient assets to support the client's lifestyle and future needs. Planning for this client group should generally focus on maximizing flexibility inside a gifting trust and, in certain cases, providing the client with some opportunity to access the trust funds at a later date. In other words, clients who might have a taxable estate may need to "eat their cake and have it too."

Clients who might have a taxable estate may wish to avoid potential estate tax upon death by making gifts to irrevocable trusts before 2026 that consume more than $7 million of their BEA and GST Exemption (or $14 million for married couples), but also provide them with some potential access to trust assets in case of significant financial need. Naturally, these strategies carry a greater risk of IRS scrutiny, where the IRS may argue that transferred assets should be included in the client's taxable estate under Code § 2036 or § 2038, because of retained interests in or rights over the assets. This risk may not be present with transactions designed for clients who should always have a taxable estate, where such clients

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72 *See, e.g.*, *id.*; Estate of Purdue v. Comm'r, 110 T.C.M. (CCH) 627, 633 (2015) (holding that gifts of LLC interests to a family trust qualified for the Annual Gift Exclusion).

73 *See, e.g.*, Estate of Wimmer v. Comm'r, T.C. Memo. 2012-157 (June 4, 2012); Fisher v. United States, 105 AFTR 2d 2010-1347 (S.D. Ind. March 11, 2010); Price v. Comm'r, T.C. Memo. 2010-2 (Jan. 4, 2010).

74 *See, e.g.*, Estate of Turner, 102 T.C.M. (CCH) at 228 (citing Treas. Reg. § 25.2503-3(c)).

75 *See, e.g.*, Estate of Wimmer v. Comm'r, 103 T.C.M. (CCH) at 1842 (citing Calder v. Comm'r, 85 T.C. 713, 727-28 (1985)).

should be able to forgo beneficial interests in transferred property. The paragraphs below explain some general considerations when designing trusts for increased flexibility, before discussing specific gifting strategies for clients who might have a taxable estate.

1. Designing Trusts for Flexibility, Generally

Designing trusts for flexibility is a balancing act. On the one hand, the client typically prefers to have significant input as to trust investments and distributions and for the trust to be flexible enough to respond to unanticipated changes in circumstances, particularly if they impact the client's own finances. On the other hand, the client also desires transfer tax savings, which often requires the client to give up some level of control over and access to the trust assets. This balancing act is even more difficult for a client who seeks to dictate his family's use and enjoyment of trust assets from the grave. Given the omnipresent threat of legislative change, however, irrevocable trusts for clients who might have a taxable estate should generally be as flexible as possible, at least during the client's lifetime, while securing transfer tax savings. Consider the following, among other factors, when designing trusts for flexibility:[76]

- Providing for an independent trustee who may make distributions of income and principal for any purpose whatsoever;
- Providing for a trust protector or advisor who can modify the trust (in certain ways), change trust situs, change governing law, add or remove beneficiaries, or grant powers of appointment;
- Including limited powers of appointment with a broad class of permissible appointees;
- Including formula general powers of appointment designed to maximize income tax basis or minimize GST taxes;
- Authorizing trust decanting, perhaps beyond what is already permitted by state statute;
- For grantor trusts, authorizing an independent trustee to reimburse the grantor for income taxes paid on behalf of the trust;
- Giving the grantor the right to swap assets with the trust or borrow from the trust;
- Facilitating the release of certain powers and interests to turn off grantor trust status if the income tax burden becomes too great for the grantor;
- Giving the grantor the right to serve as trustee (with certain tax-related restrictions), remove and replace trustees, and appoint successor trustees; and
- Limiting certain powers and provisions to apply only during the grantor's lifetime, thereby locking in certain provisions after the grantor's death.

Some of these features may increase the risk that the trust assets are subjected to the claims of the client's creditors and/or included in the client's taxable estate. Ultimately, the client must decide the level of risk that is appropriate to best accomplish the client's goals. When designing trusts for flexibility,

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[76] *See* Steve Akers, *Heckerling Musings 2019 and Estate Planning Current Developments*, p. 59 (April 2019); *see also* John F. Bergner, *The Beneficiary Flexible Trust*, 46TH ANNUAL HECKERLING INSTITUTE (2013), available at http://www.tulsaepf.org/assets/Councils/Tulsa-OK/library/Jeff%20Chadwick%20Handout.pdf.

advisors should educate clients regarding available alternatives and associated risks, draft trust agreements to best effectuate clients' objectives, and counsel clients regarding appropriate trust funding, administration, and reporting.

2. Strategies for Spouses

For two reasons, more planning options are available for married clients, compared to a single client. First, two persons have two BEAs and two GST Exemptions at their disposal (instead of just one). Second, and more importantly, many clients are comfortable naming spouses as beneficiaries of irrevocable trusts, with the hope (or, perhaps more accurately, the expectation) that if the client or the client's family has a financial need, the client's spouse will be able to receive a trust distribution to satisfy the need. The paragraphs below discuss gifting strategies that may be suitable for married clients who might have a taxable estate.

a. Utilize Only One Spouse's BEA and GST Exemption

Advisors often view married couples as a single unit for wealth transfer purposes, but it is important to remember that each spouse has a separate BEA and GST Exemption. Advisors must also remember that transfer tax exemptions come off the bottom, not the top, such that a client must give more than $7 million (or $14 million) for a married couple before 2026 to capture any benefit associated with the doubled BEA and GST Exemption prior to its expiration in 2026. For purposes of this discussion, advisors can think of this as the "gifting threshold."

One simple solution for married couples is to have only one spouse make gifts, rather than both spouses. That way, the gifting threshold is only $7 million, instead of $14 million. Consider, for example, a husband and wife with a net worth of $20 million. The couple wishes to take advantage of the currently doubled exemptions, but they are only comfortable making a total gift of $10 million. If each spouse gifts $5 million, the spouses would not exceed the gifting threshold. If the doubled exemptions expire in 2026, the spouses combined remaining BEAs would total only $4 million. In contrast, if husband made a gift of $10 million, and wife made no gifts, husband's gift would exceed the gifting threshold by $3 million. If the doubled exemptions expire in 2026, husband would have $0 of his BEA (and potentially GST Exemption) remaining, but wife would have her entire $7 million BEA and GST Exemption. In this example, therefore, if only one spouse made gifts, the couple could make total tax-free transfers of $17 million, compared to $14 million if the couple made gifts using the more traditional split gift method. The potential estate tax savings at a 40% rate would be $1.2 million.

A spouse will often transfer assets to an irrevocable trust in which the other spouse is a beneficiary. Oftentimes the trust will be structured, for income tax purposes, as a grantor trust as to the donor spouse. This trust structure requires the advisor and client to carefully consider practical consequences. A transfer of assets from one spouse in excess of the gifting threshold is likely to result in one spouse having access to substantially more wealth than the other spouse. While this dynamic may be tolerable if the spouses remain married, substantial inequities or difficulty could arise when the marriage terminates by death or divorce. While it may be possible to navigate around these issues, such as equalizing gifts between spouses before or after the initial gifting transaction, advisors must avoid possible application of the step transaction doctrine, which could undermine any potential transfer tax benefits. Moreover, advisors often represent both spouses with regard to their estate planning matters and must be mindful of the ethical duties involved in such a joint representation. Despite these potential challenges, there may be certain circumstances where utilizing only one spouse's BEA and GST Exemption makes sense.[77]

b. Spousal Lifetime Access Trusts

One of the most common planning techniques for married clients who might have a taxable estate involves at least one spouse creating an irrevocable trust for the primary benefit of the other spouse and possibly other beneficiaries, such as children and more remote descendants. These trusts are often referred to as Spousal Lifetime Access Trusts, or "SLATs." Although SLATs have existed for many years, they became extremely popular in 2011 and 2012, when the $5 million BEA was set to be replaced in 2013 with a $1 million BEA and a 55% estate tax rate. With the same dynamic at play in the years leading up to 2026, many clients are likely to consider funding SLATs with gifts in excess of the gifting threshold.

A SLAT is, in essence, a pre-funding of the bypass or credit shelter trust traditionally formed upon the death of the first spouse to die. By funding a SLAT during lifetime, instead of waiting until death, the client can take advantage of the doubled BEA and GST Exemption amounts set to expire in 2026, while also removing appreciating assets from the transfer tax system. SLATs are typically designed as grantor trusts for income tax purposes, obligating the donor spouse to pay all income tax attributable to trust income, while allowing the trust assets to grow and appreciate income tax-free. If the donor spouse is concerned he may lack sufficient funds in the future, he may take some comfort that his spouse is the primary beneficiary of the SLAT and presumably could receive a discretionary distribution that is sufficient to support the client's family (and indirectly, as a result, the client himself).

SLATs have widespread appeal as a means to save transfer taxes while also preserving assets for family use. As discussed in Part V.C.2.a, however, married clients should be mindful of how substantially funding a SLAT may impact each spouse's access to capital, particularly in the case of an unexpected death or divorce. For this reason, many married couples desire that each spouse create and fund a SLAT so that both spouses are permissible beneficiaries of transferred assets, instead of just one spouse.

A client may create and fund a trust that benefits a spouse for life and avoids inclusion of the trust assets in the spouse's taxable estate at death. If a client creates and funds a trust for the client's own benefit, however, the trust assets are generally included in the client's taxable estate under Code § 2036 or § 2038, unless the trust is properly structured as a domestic asset protection trust, as discussed in Part V.C.3.b. If each spouse creates and funds a trust for the benefit of the other spouse, the IRS may attempt to apply the "reciprocal trust doctrine," a judicially created doctrine that developed in response to the potential for gift and estate tax abuse where two transferors create trusts for each other. Where applicable, this doctrine allows the IRS to uncross each trust and treat each spouse as the creator of the trust for his or her own benefit.[78] Accordingly, if both spouses seek to create and fund a SLAT, the SLATs must be substantially different in their structure and funding to avoid the application of the reciprocal trust doctrine.

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77 For further discussion of this technique, *see* Austin Bramwell & Katie Lynagh, *The Paradoxical New Gift Splitting Calculus*, LEIMBERG ESTATE PLANNING NEWSLETTER #2713 (Apr. 1, 2019).

78 *Compare* United States v. Grace, 395 U.S. 316 (1969) and Lehman v. Comm'r, 109 F.2d 99 (2d Cir. 1939) (finding reciprocal trusts), *with* Estate of Levy v. Comm'r, T.C. Memo 1983-453 (Aug. 2, 1983) and PLR 200426008 (June 25, 2004) (not finding reciprocal trusts).

Below is a list of some, but certainly not all, of the features that planners should consider when designing SLATs:[79]

- To add general flexibility to the SLAT, consider the provisions listed in Part V.C.1;

- To facilitate broader access to the SLAT assets by the donee spouse (and possibly other beneficiaries), consider:

  - Permitting the donee spouse to serve as a trustee, with distributions limited by an ascertainable standard;

  - Giving the donee spouse the power to withdraw the greater of $5,000 or 5% of the SLAT assets each year; and

  - Authorizing an independent trustee to make distributions to the donee spouse for any purpose whatsoever, and not just for health, education, maintenance, or support;

- To give the donor spouse more control over the SLAT and, potentially, some access to the SLAT assets, consider:

  - Permitting the donor spouse to serve as a trustee, with distributions limited by an ascertainable standard;

  - Allowing the donor spouse to swap assets with the SLAT;

  - Allowing the donor spouse to borrow assets from the SLAT;

  - Giving the donee spouse or other beneficiary a limited power of appointment, exercisable during lifetime or at death (possibly only with the consent of a non-adverse party) and including the donor spouse in the class of permissible appointees;

  - Funding the SLAT with a residence that can be used by the donee spouse and the donor spouse without paying rent; and

  - In states that permit self-settled spendthrift trusts, authorizing an independent powerholder to add the donor spouse as a beneficiary or grant the donor spouse a limited power of appointment at a later date;

- To reduce the risk that the reciprocal trust doctrine applies when each spouse creates a SLAT, consider:

  - Making only one spouse a beneficiary, which is the most conservative approach;

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79 For general discussion of SLAT design options, *see* Steve Akers, *Heckerling Musings 2019 and Estate Planning Current Developments*, p. 63-65 (April 2019); see Steve Akers, *Estate Planning for Clients $10 Million and Under Estates*, HAWAII TAX INSTITUTE, p. 84-87 (Nov. 4, 2014); Ann B. Burns, *They Say You Can't Take it With You – But How Do You Give It Away? Using the $5 Million Exclusion Amount*, 46TH ANNUAL HECKERLING INSTITUTE, p. 20-22 (Jan. 2012).

- Making only one spouse a beneficiary initially, but authorizing an independent powerholder to add the other spouse as a beneficiary at later date;

- Naming different trustees for each SLAT;

- Including both spouses as beneficiaries, but with significantly different distribution provisions, such as mandatory vs. discretionary distributions, income vs. principal distributions, ascertainable vs. unlimited distribution standards, "may" consider other resources vs. "shall" consider other resources, sole beneficiary vs. multiple beneficiaries, and powers of appointment vs. no powers of appointment;

- Creating the SLATs on different dates and funding the SLATs with different assets; and

- Varying the timing and amount of distributions to each spouse;

- To address potential issues upon death or divorce, consider:

  - Having the donee spouse fund an ILIT to obtain an insurance policy on the donee spouse's life, which could provide funds for the donor spouse if he or she survives the donee spouse;

  - Requiring that the donee spouse be living and married to the donor spouse to receive distributions from the trust;

  - Defining the donor's "spouse" as the person to whom the donor is married at the time of a distribution, thereby permitting the identity of the donor's spouse to change over time; and

- To maximize creditor protection for all beneficiaries, consider:

  - Including a spendthrift provision;

  - Providing for discretionary distributions of income and principal among various beneficiaries;

  - Naming an independent person who is not related or subordinate to the grantor or any beneficiary to serve as the sole trustee or to consent to any distributions;

  - Authorizing beneficiaries to use assets, such as residential real property, rather than requiring a distribution from the SLAT; and

  - Expressly providing that any distribution is considered the beneficiary's separate property; and

- To facilitate split gifts to a SLAT, structure the spouse's beneficial interest so that it is severable, ascertainable, and de minimis.

Again, the appropriate SLAT design will be unique to each client, and certain design features carry a greater risk of estate inclusion or creditor exposure. Advisors should assist clients in carefully weighing the advantages of broader control of and access to SLAT assets against potential creditor and estate inclusion risks.

3. Strategies for All Clients Desiring Access to Gifted Property

Some clients who might have a taxable estate do not have a spouse, or even if they do, a SLAT may not be an appropriate planning vehicle. These clients should consider other planning techniques, all of which are designed to utilize the doubled BEA and GST Exemption while providing the client with some opportunity to access the gifted property in the event of financial need.

Whenever a client retains a right, however attenuated, to access gifted property, the risks of creditor exposure and estate inclusion increase. Advisors, therefore, should proceed with caution when recommending the strategies discussed below to clients, recognizing that some strategies may only be effective under the laws of certain states. Even so, some clients may be willing to assume these risks and, in fact, may not engage in any planning at all unless there is some assurance that the assets will be available if they later need them. If the planning risks materialize and assets are eventually included in the client's taxable estate, the client may view himself as no worse off than if he had done no planning at all, minus transaction costs and the opportunity cost of not pursuing other strategies.

a. Simple Methods to Preserve Access to Funds

Before getting too enamored with more exotic planning strategies, planners should remember that providing a donor with access to funds may be relatively easy. For example, if a client wishes to fund an irrevocable grantor trust for the benefit of his family members but wishes to retain some access to funds, the trust agreement could grant the client a swap power to reacquire trust assets for assets of an equivalent value, or an independent trustee could be given the ability to reimburse the grantor for income taxes paid on the trust assets.[80]

Another method of providing the client with access to trust funds is to give the client the ability to borrow assets from the trust at the applicable federal rate. A borrowing power, while simple, could provide the client with a reliable source of liquidity during times of financial need. If a loan were to be outstanding at the client's death, the client's estate should be entitled to claim an estate tax deduction for the outstanding balance.[81] Many clients may be comfortable relying on this borrowing power, with nothing more. In this sense, advisors should keep in mind to not let "perfect" get in the way of "good enough."

In addition to basic design considerations, a client who might have a taxable estate may also favor estate planning transactions that provide the client with a steady cash flow. The most common example is an installment sale to a grantor trust, in which the client sells assets to a trust in exchange for a promissory note (or in some cases, a private annuity). Interest and principal payments on the note (or annuity payments) should provide the client with liquidity, while any future appreciation in the transferred property should occur outside of the transfer tax system as to that client. Moreover, for clients who are not ready to consume their entire BEA and GST Exemption now, but may wish to give more prior to 2026, a current installment sale would facilitate a quick and easy future gift through the client's forgiveness of all or a portion of the outstanding promissory note. There are many considerations in

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[80] *See generally* Clay Stevens, *The Reverse Defective Grantor Trust*, TR. & ESTS. 33 (Oct. 2012).

[81] For a good discussion of how loans from a trust can provide a "back-door" for cash flow, along with deductibility of an outstanding loan in the client's estate, see Steve Akers, *Estate Planning for Clients $10 Million and Under Estates*, HAWAII TAX INSTITUTE, p. 84 (Nov. 4, 2014).

structuring an installment sale transaction, including initial trust funding, designing the purchase agreement and promissory note, and, if applicable, navigating guarantee fees.[82]

b. Domestic Asset Protection Trusts

If a client could describe the ultimate "eat your cake and have it too" transaction, it likely would be an irrevocable trust created by the client, that is funded by the client with assets that consume the doubled BEA and GST exemption, is protected from the client's creditors, is excluded from the client's taxable estate at death, and yet still permits the client to be a permissible beneficiary. Well, such trusts do exist and are often referred to as self-settled spendthrift trusts, or more colloquially, asset protection trusts.[83] Before 1997, asset protection trusts were only available offshore in jurisdictions such as the Bahamas, Bermuda, and the Cayman Islands. In 1997, however, Alaska authorized asset protection trusts. Since then, a flurry of other states enacted similar legislation, resulting in 19 jurisdictions currently authorizing some form of "domestic" asset protection trust, or "DAPT."[84]

A DAPT, in its purest form, would allow an independent trustee to make discretionary distributions of income and principal to or for the benefit of the grantor. A more conservative approach, however, would be to create a DAPT that does not name the grantor as a beneficiary but authorizes an independent powerholder to add the grantor as a discretionary beneficiary at a later date. This approach should provide another layer of insulation between the grantor and the trust, which may help if the trust is challenged by a creditor or the IRS.

However, DAPTs are not for the faint of heart. Even if a client forms a DAPT in a state that authorizes self-settled spendthrift trusts, the DAPT is not immune from challenge, in particular if the grantor does not reside in the state in which the DAPT is created or otherwise maintain sufficient minimum contacts with the state. Depending on the client's solvency at the time the DAPT is created, there may also be fraudulent transfer concerns. Because DAPTs have been challenged successfully in bankruptcy courts,[85] clients should first consider whether more conservative alternatives are available to accomplish their planning goals.

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82 For further discussion of installment sale planning, see Ann B. Burns, *They Say You Can't Take it With You – But How Do You Give It Away? Using the $5 Million Exclusion Amount*, 46TH ANNUAL HECKERLING INSTITUTE, p. 27-29 (Jan. 2012).

83 *See* PLR 200944002 (Oct. 30, 2009) (finding that an asset protection trust formed under an applicable state statute should not be included in the grantor's taxable estate, but declining to rule on whether other facts, including a pre-existing arrangement between the grantor and trustee, would cause estate inclusion under IRC § 2036).

84 DAPT states include Alaska, Delaware, Nevada, New Hampshire, South Dakota, and Virginia, among others. For a general discussion of DAPTs, including citations to DAPT statutes, see Alexander A. Bove, Jr. & Melissa Langa, *The Growing Asset Protection Trust Movement Adds Indiana and Connecticut to the List*, LEIMBERG INFORMATION SERVICES, INC., Asset Protection Newsletter #393 (Sept. 26, 2019); *see also* Richard S. Franklin & George D. Karibjanian, *The Lifetime QTIP Trust – the Perfect (Best) Approach to Using Your Spouse's New Applicable Exclusion Amount and GST Exemption*, BLOOMBERG ESTATES, GIFTS, AND TRUSTS, NUMBER 2 (Mar. 14, 2019).

85 *See* Waldron v. Huber (In re Huber), 493 B.R. 798 (Bkrtcy. W.D. Wash. May 17, 2013) (disregarding an Alaska DAPT because the State of Washington has a strong public policy against DAPTs); Battley v. Mortensen, Case No. A09-00565-OMD Adv. No. A09-90036-DMD (Bkrtcy. D. Alaska May 26, 2011) (ruling that an Alaska DAPT was not protected under federal bankruptcy law).

c. Special Power of Appointment Trusts

Some clients may believe DAPTs are too risky, despite their potential benefits. An alternative technique involves the creation of an irrevocable spendthrift trust for the benefit of one or more beneficiaries, not including the grantor, in which a beneficiary or non-beneficiary is given a limited power to appoint the trust assets among a class of persons, including the grantor. Trusts with this feature are sometimes referred to as special power of appointment trusts, or "SPATs."[86] This technique, if it works as intended, should enable a client to currently make use of the doubled BEA while having the possibility to benefit from the assets.

Conceptually, SPATs are similar to the upstream planning discussed in Part II.B.3, in that each technique involves a transfer of property to a beneficiary, with the possibility that the transferred property returns to the donor (or a trust for the donor's benefit). Unlike upstream planning, however, which is primarily designed to maximize income tax basis for the transferred assets through inclusion of those assets in the estate of an older beneficiary with excess BEA, a SPAT is typically structured to avoid inclusion of the assets in the beneficiary's estate. Specifically, upstream trusts will often grant beneficiaries a general power of appointment to cause estate inclusion, while SPATs usually only grant beneficiaries or third parties limited powers of appointment to avoid a taxable gift or estate inclusion.

SPATs offer considerable appeal for clients who might have a taxable estate given the possibility that the trust assets could be available to the donor, or pass to a trust for the donor's benefit, through a third party's exercise of a lifetime or testamentary limited power of appointment. There are, however, several risks associated with SPATs. If a portion of the SPAT assets are appointed back to a donor, the IRS could argue that the all of the trust's assets should be included in the donor's taxable estate under Code § 2036 pursuant to an implied agreement between the donor and the powerholder at the time the SPAT was created. In addition, if a donor creates a SPAT and the holder of a limited power of appointment directs the SPAT assets to an appointive trust for the benefit of the donor, the appointive trust should not grant the donor a lifetime or testamentary power of appointment. The IRS could assert that the donor essentially retained the right to alter, amend, revoke, or terminate the trust and, therefore, the assets should be included in the donor's taxable estate under Code § 2038.[87]

In addition to estate inclusion issues under Code § 2036 and § 2038, there is a separate, but related creditor rights issue under state law. Under the law of some states, there is a risk that the appointive trust "relates back" to the original donor of the SPAT, such that the appointive trust is actually a self-settled trust and therefore exposed to the claims of the donor's creditors.[88] This issue might be avoided if the appointive trust (and potentially the SPAT) is governed by the law of a state permitting DAPTs or the applicable state law offered specific protection to appointive trusts under these facts. A number of states, including Delaware, Florida, Virginia, and Wyoming, protect appointive trusts created

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86 *See* Abigail E. O'Connor, Mitchell M. Gans, & Jonathan G. Blattmachr, *SPATs: A Flexible Asset Protection Alternative to DAPTs*, 46 ESTATE PLANNING 3 (Feb. 2019).

87 For further reading regarding potential estate inclusion issues associated with SPATs, see Steve Akers, *Estate Planning for Clients $10 Million and Under Estates*, HAWAII TAX INSTITUTE, p. 87-89 (Nov. 4, 2014).

88 *See* Barry Nelson, *Asset Protection & Estate Planning – Why Not Have Both?*, 46TH ANNUAL HECKERLING INSTITUTE (Jan. 2012).

pursuant to an inter vivos QTIP trust. A more limited number of states, including Arizona, Ohio, and Texas, extend this protection to other trusts, such as SLATs.[89]

If a client is considering a SPAT, it would be best to situs the SPAT (and subsequent appointive trust) in a DAPT state, or a state, like Texas, that would extend spendthrift protection to the appointive trust. As an added layer of protection, the appointive trust could not name the client as an initial beneficiary, but could provide that an independent person may add the client as a beneficiary at a later date. Regardless of the client's preferred structure, the planner should also take care to avoid application of the step transaction doctrine.

d. Retained Interest Gifts

Under the estate tax "string provisions" contained in Sections 2035 - 2039, and 2042 of the Code, a taxpayer can make a completed taxable gift during lifetime, but the gifted asset can still be included in the taxpayer's gross estate upon death.[90] For example, if a parent gifts a remainder interest in property to a child, but retains a life estate in the property, the property will still be included in the parent's estate under Code § 2036. This basic concept, combined with the anti-clawback provision in the Regulations[91] and the exception of assets included in the gross estate from adjusted taxable gifts,[92] may enable clients to make use of the doubled BEA by making completed taxable gifts prior to 2026, while still enjoying the property during their lifetimes.

In theory, retained interest gifts should not generate any additional estate tax. Code § 2001(b) removes assets included in the gross estate from adjusted taxable gifts. Although the asset itself, at its date-of-death value, is included in the gross estate, its inclusion is offset under the Regulations by the increased BEA utilized when the lifetime gift was made. Consequently, the only amount that should be subject to estate tax is the post-gift appreciation.[93]

Given their attractiveness to clients who might have a taxable estate, advisors may be tempted to recommend retained interest gifts, such as a retained income gift trust, an enhanced grantor retained income trust, or an intentionally defective 2701 transaction.[94] Advisors, however, should be extremely wary in recommending these types of transactions to clients.[95] Retained interest gifts are inherently risky

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89 *See, e.g.*, TEX. PROP. CODE § 112.035(d)(2) (providing that a settlor is not considered a trust beneficiary by reason of a third party's exercise of a power of appointment); § 112.035(g) (providing that the original donor is not considered the settlor of an inter vivos QTIP trust or SLAT after the death of the donor's spouse).

90 *See generally* Matthew A. Reiber, *Untangling the Strings: Transfer Taxation of Retained Interests and Powers,* 48 AKRON L. REV. 3 (Sept. 2015).

91 *See* Treas. Reg. § 20.2010-1(c) (providing that if a taxpayer makes a lifetime gift utilizing BEA in excess of the BEA at the taxpayer's death, the taxpayer's BEA will be the higher gifted amount for purposes of calculating any estate tax due).

92 *See* IRC § 2001(b) (providing that gifts includible in the gross estate of a decedent shall not be counted as adjusted taxable gifts for purposes of calculating estate tax).

93 *See* Steve Akers, *Heckerling Musings 2019 and Estate Planning Current Developments*, p. 12-13 (April 2019).

94 For a broader discussion of retained income gifts, see Jeff Chadwick, *To Gift or Not To Gift: Balancing Income and Transfer Tax Benefits for Couples Between $12 Million and $22 Million*, 46TH ANNUAL NOTRE DAME TAX & ESTATE INSTITUTE, October 28, 2020.

95 In addition to transfer tax risks, retained interest gifts only utilize the doubled BEA, but not the GST Exemption, because the GST Exemption cannot be allocated until the close of the estate tax inclusion period ("ETIP"). With a retained interest gift, the ETIP does not close until the client's death, at which point the

in this context. After all, clients would be using complex tax rules as a sword, when they were intended for use by the IRS as a shield.

Before the anti-clawback Regulations were finalized, the Tax Section of the New York State Bar Association advised the IRS that the Proposed Regulations, as drafted, "would permit individuals to make relatively painless taxable gifts that lock in the increased exclusion amount, even though they retain beneficial access to the transferred property." They asked the IRS to "consider further whether gifts included in a decedent's gross estate should successfully lock in the temporarily increased exclusion amount available before 2026."[96] The IRS declined to include an anti-abuse provision in the final Regulations, but did note that such a provision was within the scope of its regulatory authority. Sure enough, in 2022, the IRS released Proposed Regulations that, if enacted, would essentially eliminate the possibility of clients utilizing certain retained interest gifts in the manner described above.[97] As a result, most forms of creative retained interest gifts (other than GRATs and similar statutorily authorized techniques) do not appear to be a viable planning tool for clients who might have a taxable estate.

VI. CONCLUSION

While estate planning has never been easy, it seems even harder now in the face of legislative uncertainty and constantly changing exemption amounts. Advisors can generally slot clients into one of three groups based on current and projected net worth—(i) clients who are *unlikely* to have a taxable estate, (ii) clients who are *likely* to have a taxable estate, and (iii) clients who *might* have a taxable estate. Clients who might have a taxable estate are the most challenging group for planners because they are stuck in the middle of the expiring exemption amounts.

Core estate planning for clients who might have a taxable estate requires a keen understanding of available alternatives, including traditional bypass trusts, portability, and disclaimer-based planning. Lifetime gifting for this client group may also require creative solutions designed to utilize the client's increased BEA and GST Exemption prior to 2026, while potentially permitting the client to access the gifted property directly or indirectly in the future. The best approach generally requires learning as much about the client as possible, including the client's tax and non-tax objectives, as well as the client's ongoing financial needs and cash flow. For many clients, it is more appropriate to plan for income tax savings, rather than transfer tax savings, and planners must learn to adapt to this new planning environment.

As evident from this paper, no one approach fits all, and each client's estate plan should be specifically tailored to that client's unique financial and family situation. Flexibility is key, balanced with a heavy dose of practicality. Planners should take comfort that, regardless of the future of the transfer tax system, good advice will always be in demand.

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increased GST Exemption may have already expired. Therefore, retained interest gifts are not appropriate for clients who desire to utilize their doubled GST Exemption.

96 *See* New York Bar Association, Tax Section, *Report No. 1410 – Report on the Proposed Section 2010 Regulations* (Feb. 20, 2019), available at https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2019/1410_Report.html.

97 *See* Prop. Treas. Regs. § 20.2010-1(c)(3), 87 Fed. Reg. 24918 (Apr. 27, 2022) (providing an exception to the general anti-clawback rule for certain retained interest gifts.)

Exhibit 1

MEMORANDUM

TO: Client

FROM: Estate Planning Attorney

DATE: June 17, 2022

RE: Overview of Federal Transfer Taxation

This memorandum provides a brief overview of a number of federal transfer tax concepts and a related income tax cost basis adjustment, which we hope will be helpful to you in reviewing and understanding draft core estate planning documents being sent to you by letter of even date herewith.

FEDERAL TRANSFER TAXES

Under federal law, there are three separate, but somewhat related, types of transfer taxes: the gift tax, the estate tax, and the generation-skipping transfer tax.

Gift Tax and Estate Tax. The federal gift and estate taxes are interrelated. The gift tax applies to the transfer of property during life, and the estate tax applies to the transfer of property at death. Each taxpayer has an $12.06 million exclusion from federal gift and estate tax (the "Basic Exclusion Amount"), which is reduced by any exclusion used in prior years. The Basic Exclusion Amount will be increased annually through 2025 to account for inflation. Gifts during life or bequests at death that exceed a taxpayer's Basic Exclusion Amount are subject to a 40% gift or estate tax.[98]

Marital and Charitable Deductions. A taxpayer's gifts during life or bequests at death to a U.S. citizen spouse (or certain marital trusts) receive an unlimited marital deduction from federal gift and estate taxes and do not consume a taxpayer's Basic Exclusion Amount. Similarly, gifts during life or bequests at death to charity (or certain charitable trusts) receive an unlimited charitable deduction.

GST Tax. The federal generation-skipping transfer ("GST") tax is designed to deter taxpayers from making transfers to individuals who are two or more generations below the transferor (such people are referred to as "Skip Persons"). Each taxpayer has an $12.06 million exemption from GST tax (the "GST Exemption"), reduced by any GST Exemption used in prior years. The GST Exemption will be increased annually through 2025 to account for inflation. It can be applied to direct gifts or bequests to Skip Persons, or it can be allocated to trusts that may ultimately benefit Skip Persons in the future. The

[98] Certain types of gifts during life do not count, however, against a taxpayer's Basic Exclusion Amount. A taxpayer may give up to $16,000 per year (the "Annual Gift Exclusion") to as many individuals as he or she likes without paying gift taxes or utilizing any portion of the taxpayer's Basic Exclusion Amount. Note that if such gift is made in trust, the trust must be structured appropriately in order to qualify for the Annual Gift Exclusion. The Annual Gift Exclusion will be adjusted for inflation in future years. Additionally, a taxpayer may make unlimited direct payments of qualified medical and qualified education expenses on behalf of any number of individuals without using any of the taxpayer's Basic Exclusion Amount or Annual Gift Exclusion.

GST tax rate for transfers not covered by the transferor's GST Exemption is 40%. GST tax can apply during life or at death.[99]

Sunset. Please note that the exemptions discussed above are only effective for transfers made and persons passing away from 2022 through 2025. In 2026, the Basic Exclusion Amount and GST Exemption are set to decrease to $5 million per person, indexed for inflation.

FEDERAL INCOME TAX BASIS

Under federal income tax law, when a taxpayer sells an asset for an amount greater than its cost basis, the excess amount is subject to capital gain tax.

Cost Basis Adjustment. Assets included in a taxpayer's estate at death receive a new income tax basis equal to the asset's fair market value on the date of the taxpayer's death. If an asset has appreciated since being acquired by the taxpayer, the asset will receive a "step-up" in income tax basis for purposes of calculating capital gain upon the post-death sale of the asset. On the other hand, if the asset has depreciated in value since its acquisition, the asset's income tax basis will "step-down." This adjustment does not apply to assets that constitute "income in respect of a decedent," which includes most IRAs, 401k's, and other qualified retirement assets.

PORTABILITY AND TRADITIONAL FAMILY TRUST PLANNING

Traditional Family Estate Planning. Estate planning for married couples has traditionally revolved around utilizing, to the fullest extent possible, the Basic Exclusion Amount of the first spouse to die at the time of the first spouse's death. Under prior law, if the first deceased spouse's Basic Exclusion Amount was not fully utilized, such unused amount would be wasted. Typically, spouses intending to minimize estate tax would structure their estate plans to provide that upon the first spouse's death, assets of the deceased spouse's estate having a date-of-death value up to the deceased spouse's Basic Exclusion Amount would be administered in an irrevocable "Family Trust" for the primary benefit of the surviving spouse. As explained below, however, legislation introduced the concept of "portability" several years ago, which provides married couples with new flexibility in planning their estates to take advantage of both spouses' Basic Exclusion Amounts without the need for traditional Family Trust planning at the first spouse's death.

Portability. With portability, upon the death of the first spouse to die, the surviving spouse can utilize or "port" the unused portion of the deceased spouse's Basic Exclusion Amount.[100] Consequently, the first spouse to die can leave all assets to his or her surviving spouse, outright and free of trust, or in a trust qualifying for the unlimited marital deduction, and, in certain circumstances, the surviving spouse can utilize the deceased spouse's unused Basic Exclusion Amount during the surviving spouse's life or at

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99 Certain types of gifts during life do not count against a taxpayer's GST Exemption. A taxpayer may give up to $16,000 per year (the "Annual GST Exclusion") to as many Skip Persons as he or she likes without paying GST tax or utilizing any portion of the taxpayer's GST Exemption. Note that if such gift is made in trust, the trust must be structured appropriately in order to qualify for this Annual GST Exclusion. *Note, also, that a trust may be structured to qualify for the Annual Gift Exclusion but might not qualify for the Annual GST Exclusion.* In addition, a taxpayer may make unlimited direct payments of qualified medical and qualified educational expenses for or on behalf of Skip Persons without using any of his or her GST Exemption or Annual GST Exclusion.

100 Although the deceased spouse's unused Basic Exclusion Amount is referred to in the Internal Revenue Code and related forms and commentary as the "DSUE amount," this term is not used in this memorandum.

death.[101] For example, if the first spouse were to die in 2022 without using any of his or her Basic Exclusion Amount, the surviving spouse could port the deceased spouse's unused Basic Exclusion Amount by adding it to the surviving spouse's own Basic Exclusion Amount, resulting in a $24.12 million "Applicable Exclusion Amount" available to the surviving spouse.

Advantages and Disadvantages of Portability and Traditional Family Trust Planning. There are advantages and disadvantages of both planning strategies: using portability to add the first deceased spouse's unused Basic Exclusion Amount to the surviving spouse's Basic Exclusion Amount; or using the deceased spouse's Basic Exclusion Amount in the deceased spouse's own estate by requiring the funding of a Family Trust.

Using Portability. Portability has several advantages and disadvantages, some of which are discussed below.

Some of the advantages of portability are as follows:

- *Simplicity*. The surviving spouse is not required to administer a separate irrevocable trust (a Family Trust) or file separate annual income tax returns for that trust.

- *New Income Tax Basis*. The assets owned by the surviving spouse at his or her death (including those received from the first spouse to die, either outright or in a trust qualifying for the marital deduction, a "Marital Trust") receive a new income tax basis at the surviving spouse's death. In contrast, the assets of a Family Trust do not receive a new income tax basis at the surviving spouse's death.

- *Retirement Plans*. Portability allows clients to optimize the income tax benefits of naming a surviving spouse as the primary beneficiary of IRAs and 401k's. This allows for greater income tax deferral on those retirement assets as compared with designating a Family Trust as beneficiary, while the deceased spouse's unused Basic Exclusion Amount can be retained for later use by the surviving spouse.

Some of the disadvantages of portability are as follows:

- *Estate Tax Return Filing Requirement*. Even if the value of a deceased spouse's estate is less than the $12.06 million threshold at which an executor is required to file a federal estate tax return (Form 706), in order to take advantage of portability, a deceased spouse's executor must file a Form 706 to calculate and report the deceased spouse's unused Basic Exclusion Amount.

- *Possibility of Loss*. If the surviving spouse remarries and the new spouse dies before the surviving spouse has utilized the unused Basic Exclusion Amount of the first spouse to die, the surviving spouse loses the first deceased spouse's unused Basic Exclusion Amount.

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[101] A surviving spouse may only utilize the unused Basic Exclusion Amount of his or her most recently deceased spouse. Thus, individuals cannot collect portable Basic Exclusion Amounts from multiple deceased spouses.

- *No Creditor or Spousal Protection*. Assets received outright by a surviving spouse are left exposed to the potential claims of creditors. In addition, a surviving spouse can dispose of assets received outright from the deceased spouse without limitation (*e.g.*, to some children to the exclusion of others, to a new spouse, to influential caregivers, or to charitable or other organizations).[102]

- *No Utilization of GST Exemption*. Unlike the Basic Exclusion Amount, the deceased spouse's unused GST Exemption cannot be ported to the surviving spouse.

Funding Traditional Family Trust. While portability has its advantages and disadvantages, the creation and funding of a Family Trust upon the first spouse's death can be a more effective estate planning strategy for some married couples. It also has disadvantages. Some advantages and disadvantages to this approach are discussed below.

Some of the advantages of traditional Family Trust planning are as follows:

- *Future Income and Appreciation Can Be Shielded from Estate Taxation*. The first deceased spouse's unused Basic Exclusion Amount is not indexed for inflation occurring between the deaths of the spouses. In contrast, the assets of a Family Trust should pass free of estate tax at the surviving spouse's death, including all accumulated income in the Family Trust and all appreciation in the Family Trust's assets since the death of the first spouse to die.

- *Possibly No Estate Tax Return Required*. If the first deceased spouse's estate is less than his or her Basic Exclusion Amount, all assets can pass to a Family Trust without the need to file a Form 706 for the deceased spouse's estate.

- *Creditor and Spousal Protection*. The assets of a Family Trust receive additional protection from creditors and can limit the ability of a surviving spouse to cause the assets of the Family Trust to pass outside the family line.[103]

- *Utilization of GST Exemption*. The deceased spouse's GST Exemption can be allocated to the Family Trust and enable those assets, plus accumulated income and appreciation, to pass free of transfer taxes for multiple generations.

Some of the disadvantages of traditional Family Trust planning are as follows:

- *Additional Income Tax Returns*. The surviving spouse or whomever is the acting Trustee of the Family Trust must file annual fiduciary income tax returns (Forms 1041) for the Family Trust.[104]

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102 These disadvantages are not applicable, however, if and to the extent the first spouse to die leaves assets to a trust qualifying for the marital deduction for the lifetime benefit of the surviving spouse, a Marital Trust.

103 These advantages also apply with portability planning if and to the extent the first spouse to die leaves assets to a Marital Trust.

104 These disadvantages also apply with portability planning if and to the extent the first spouse to die leaves assets to a Marital Trust.

- *3.8% Surtax*. If the Family Trust has over $13,450 of unearned income, *e.g.*, net investment income that is not distributed to a beneficiary, this income will be subject to a 3.8% surtax. In contrast, a single individual is subject to this surtax at $200,000 of unearned income.

- *Fiduciary Responsibility*. The surviving spouse or whomever is acting as Trustee of the Family Trust will have fiduciary duties to the beneficiaries, *i.e.*, the surviving spouse and, typically, other beneficiaries such as children and grandchildren, either during the surviving spouse's lifetime or as remainder beneficiaries upon the surviving spouse's death.[7]

Personal Planning Objectives. For married couples, determining whether to rely on portability or to engage in traditional Family Trust planning will depend on the unique circumstances of each couple, including the couple's assets and liabilities, as well as the priorities placed by the couple on the advantages and disadvantages of each planning technique, as noted above.

Exhibit 2

Sample Disclaimer Clauses

Assets Outright to Surviving Spouse, with Option for Disclaimer Family Trust

Upon Husband's death, the Trustee shall distribute Husband's property to Wife, free of trust. However, if Wife makes a qualified disclaimer, as permitted under Section 2518 of the Code, with respect to all or any portion of Husband's property, then unless the instrument of disclaimer specifically disclaims all beneficial interests in such property, the property subject to the disclaimer (including any interest of persons other than Wife) shall be administered in a separate trust known as the Disclaimer Family Trust as provided in Section ___.

Assets to Marital Trust, with Option for Disclaimer Family Trust

Upon Husband's death, the Trustee shall administer Husband's property as a separate trust known as the Marital Trust, as provided in Section ___. However, if Wife makes a qualified disclaimer, as permitted under Section 2518 of the Code, with respect to all or any portion of Husband's property to be administered in the Marital Trust, then unless the instrument of disclaimer specifically disclaims all beneficial interests in such property, the property subject to the disclaimer (including any interest of persons other than Wife) shall be administered in a separate trust known as the Disclaimer Family Trust as provided in Section ___.

Exhibit 3

DEED OF GIFT

STATE OF TEXAS	§	
	§	KNOW ALL MEN BY THESE PRESENTS THAT:
COUNTY OF HARRIS	§	

SUSAN A. BROWN hereby transfers to JIM BROWN, as Trustee of The ABC Trust (the "Trust"), Sixteen Thousand and No/100 Dollars ($16,000.00) (the "Gift"), subject to the following terms and conditions:

1. The withdrawal rights granted under Paragraph 4.3(a)(i) of the Trust Agreement creating the ABC Trust (the "Trust Agreement") shall not apply to the Gift.

2. Each Beneficiary (as that term is defined in Section 1.4 of the Trust Agreement) shall have the right to withdraw the Gift, subject to the provisions of Subsections 4.3(c) and (d) of the Trust Agreement and the provisions of this Deed of Gift.

3. The Trustee shall promptly provide written notice to the Beneficiary as provided in Subsection 4.3(b).

4. If the Beneficiary does not exercise the withdrawal right within thirty (30) days of receipt of the written notice of the withdrawal right described in Subsection 4.3(b), the unexercised right shall lapse at that time, but only to the extent such unexercised withdrawal right does not exceed the Unused Five and Five Amount. To the extent that the Beneficiary's withdrawal right does not lapse completely as provided in the previous sentence, such excess amount shall be added to and aggregated with the balance of Beneficiary's Unlapsed Withdrawal Rights and shall continue to be subject to the Beneficiary's right of withdrawal until such rights lapse as provided in paragraph 5 below.

5. The amount of a Beneficiary's Unlapsed Withdrawal Rights shall lapse on January 1 of each calendar year, but only to the extent that such lapse shall not exceed the Five and Five Amount. The excess portion of the Unlapsed Withdrawal Rights shall continue to be subject to the Beneficiary's right of withdrawal until January 1 of the next calendar year, on which date the current balance of the Beneficiary's Unlapsed Withdrawal Rights shall lapse as provided in the previous sentence.

6. The following definitions shall apply to this Deed of Gift:

   a. <u>Five and Five Amount</u>. The term "Five and Five Amount" means, with respect to a Beneficiary, the greater of (A) Five Thousand Dollars ($5,000), or (B) Five Percent (5%) of the total value of the ABC Trust determined as of the date the current withdrawal right is to lapse or (C) any greater withdrawal right, the lapse of which would not constitute a release of such withdrawal right under Sections 2041(b)(2) and 2514(e) of the Internal Revenue Code or any similar subsequent statute.

   b. <u>Unlapsed Withdrawal Rights</u>. The term "Unlapsed Withdrawal Rights" means the cumulative balance of a Beneficiary's withdrawal rights over the assets of the ABC Trust that have not lapsed.

c. Unused Five and Five Amount. The term "Unused Five and Five Amount" means the amount of a Beneficiary's cumulative withdrawal rights with respect to any other gifts from any transferor that are either currently outstanding or that have previously lapsed (but not including the present right of withdrawal) during the same calendar year less the Five and Five Amount.

EFFECTIVE this 31st day of December, 2022.

____
SUSAN A. BROWN

JIM BROWN hereby acknowledges and accepts the receipt of this Deed of Gift in his capacity as Trustee of the ABC Trust.

____
JIM BROWN

Exhibit 4

Jim Brown, Trustee
The ABC Trust
1234 Avenue B

Houston, Texas 77002

December 31, 2022

Mary Brown
1234 8th Street
Houston, Texas 77002

Re: The ABC Trust (the "Trust")

Dear Mary:

In my capacity as Trustee, I am sending this letter to you as a beneficiary of the above-referenced Trust.

Please be advised that on December 31, 2022, your mother transferred property to the Trust. As a beneficiary of the Trust, you have a right to withdraw a portion of such property. Your withdrawal rights are set forth in the attached Deed of Gift. The description of the property added to the Trust, the amount or portion thereof over which you have a present right of withdrawal, and the date of expiration of this right are described below:

1. **Description of property and value:** Sixteen Thousand and No/100 Dollars ($16,000.00).

2. **Amount over which you hold a right of withdrawal:** The amount described in the attached Deed of Gift.

3. **Date of expiration of right of withdrawal:** 30 days from the date you receive this letter.

You may withdraw all or any portion of the amount over which you hold a right of withdrawal at any time prior to the date of expiration. In the event you wish to make a withdrawal, please advise me in writing at the above address of the amount you wish to withdraw. To be effective, such exercise of a right of withdrawal must be postmarked or received by me no later than the date of expiration. In the event this notice is received by a natural or appointed guardian of an incompetent, whether because of minority or some other infirmity, and this right of withdrawal is to be exercised, the guardian shall obtain the signature of the minor or ward in addition to his or her own, if at all possible and after explaining the rights contained herein.

This notice is a condition to the contribution to the Trust of the above-described property. The amount subject to this withdrawal right is payable in cash immediately upon receipt by me, as Trustee, of your demand in writing. Should the Trust not contain sufficient liquid assets to satisfy a demand when made, I can and will borrow funds (from the settlor of the trust or another source) in order to satisfy the withdrawal and can, if necessary, pledge trust property to secure the loan.

Whether or not this withdrawal right is exercised, please sign and date the bottom of this letter and return a copy to me for my records. The natural or appointed guardian may sign and date the bottom of this letter on behalf of an incompetent, whether because of minority or some other infirmity. If possible, the guardian should obtain the signature of the minor or ward in addition to his or her own in acknowledging receipt of this notice.

Sincerely,

____
Jim Brown, Trustee

I hereby acknowledge receipt of the foregoing notice.

Date:__________________________ ____
Mary Brown, Beneficiary