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Advanced Gifting Strategies for Estate Planners: Balancing Income and Transfer Tax Benefits for Individuals, Couples

THURSDAY, JANUARY 6, 2022

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Advanced Gifting Strategies for Estate Planners:

Balancing Income and Transfer Tax Benefits
for Couples, Individuals

Wayne M. Zell



Overview

- Gift tax and transfer planning
 - Transfer planning generally
 - Techniques
- 2021 Tax Legislation, the Future and Retroactivity
 - Planning to avoid problems with retroactivity

Gift strategies in general

- Use exemption before it is reduced
 - Avoid reciprocal trusts
 - Allocate GST (including late allocations where value has declined) to existing trusts
 - Consider risk of value decline post-gift
- Consider gift of asset with *temporarily* reduced value
- Use disclaimers to hedge risk of retroactive legislation (*see below*)
 - Gift to marital trust, disclaimer to gift trust, but spouse can't be beneficiary of gift trust, be trustee beyond HEMS or have power of appointment
- Must consider impact on basis and income tax effects

Gift now vs. waiting until death

Always consider basis of gifted assets vs. benefit of basis step-up @ death

- Low basis assets must appreciate to offset loss of tax savings from basis step-up at death
- Age and health of donor and nature of assets may affect strategy

Example:

- Larry has \$10 million of applicable exclusion remaining that he uses to make a gift of stock worth \$10 million to an irrevocable trust for his daughter. His basis in the stock at the time of the gift is \$500,000. When Larry dies 5 years later, the value of the stock has increased to \$25 million. Larry lives in Virginia (no estate tax; income tax rate of 5.75%).
- Estate tax savings from the transfer = \$6,000,000 (40% federal estate tax rate x \$15MM of post-transfer appreciation on the stock).
- If stock is sold, trust incurs capital gains tax = \$7.965MM in tax (20% capital gains rate + 3.8% NIIT + 5.75% VA tax + 5% surtax on MAGI > \$10MM).
- So, the lifetime transfer of the stock has a **net tax cost** of \$1.965MM to the trust.

Gifting Techniques

- Transfers not subject to gift tax – tuition, medical, annual exclusion gifts
- Complete vs. incomplete gifts – DINGs, NINGs and other INGs
- Gifts in trust
 - SLATs
 - GRATs
 - ILITs
 - QPRTs
 - Part-gift, part-sale
- Full consideration transfers
 - Sales and installment sales – grantor and non-grantor trusts
 - SCINs
 - Private annuities
- Charitable transfers – CLTs, CRTs
- Future legislation?

Incomplete Nongrantor Trusts

- Incomplete-gift nongrantor trust created in a state with no state income tax on trusts (DE, NV, WY, SD):
 - State allows for the creation of self-settled spendthrift trusts (avoids grantor trust status)
 - Grantor retains testamentary limited power of appointment, so that a completed gift is not made upon funding the trust
 - Grantor retains right to receive cash flow distributions with consent of an “adverse” party
 - Grantor funds the trust with a low-basis assets Grantor intends to sell
- *But see* Waldron v. Huber (In re Huber), 493 BR 798 (Bankr. W.D. Wash. 2013) – Washington grantor could not avoid the claims of his creditors by creating and funding an Alaska self-settled spendthrift trust; void because it would not have been allowable under Washington law; treated as grantor trust

Spousal Lifetime Access Trust

- Irrevocable trust in which a spouse creates a trust for the benefit of the other spouse (and his/her heirs).
- Spouse-beneficiary can be trustee, limit distributions to ascertainable standard
- Spouse-beneficiary cannot contribute assets to trust (treated as self-settled if spouse-beneficiary contributes assets)
- Grantor may be reimbursed for income taxes by independent trustee – Rev. Rul. 2004-64
- None of those rights will alone cause the trust to be includible in the federal gross estate of the spouse-beneficiary
- Grantor trust if spouse-beneficiary entitled to receive income

Spousal Lifetime Access Trust (cont'd)

- Depending on state law, grantor may reacquire interest in SLAT through spouse-beneficiary's exercise of a limited power of appointment. *Ltr. Rul. 9140069*; but see *Ltr. Rul. 9128005*.
- SLATs for each spouse – beware of reciprocal trust doctrine
 - “[T]he application of the reciprocal trust doctrine requires only that the trusts be interrelated, and that the arrangement, to the extent of mutual value, leaves the [grantors] in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries.” *Estate of Grace v. United States*, 395 U.S. 316, 324 (1969).
 - Create differences between the two trusts that arguably make them unrelated and “non-reciprocal”

Some Suggested Differences In SLATs

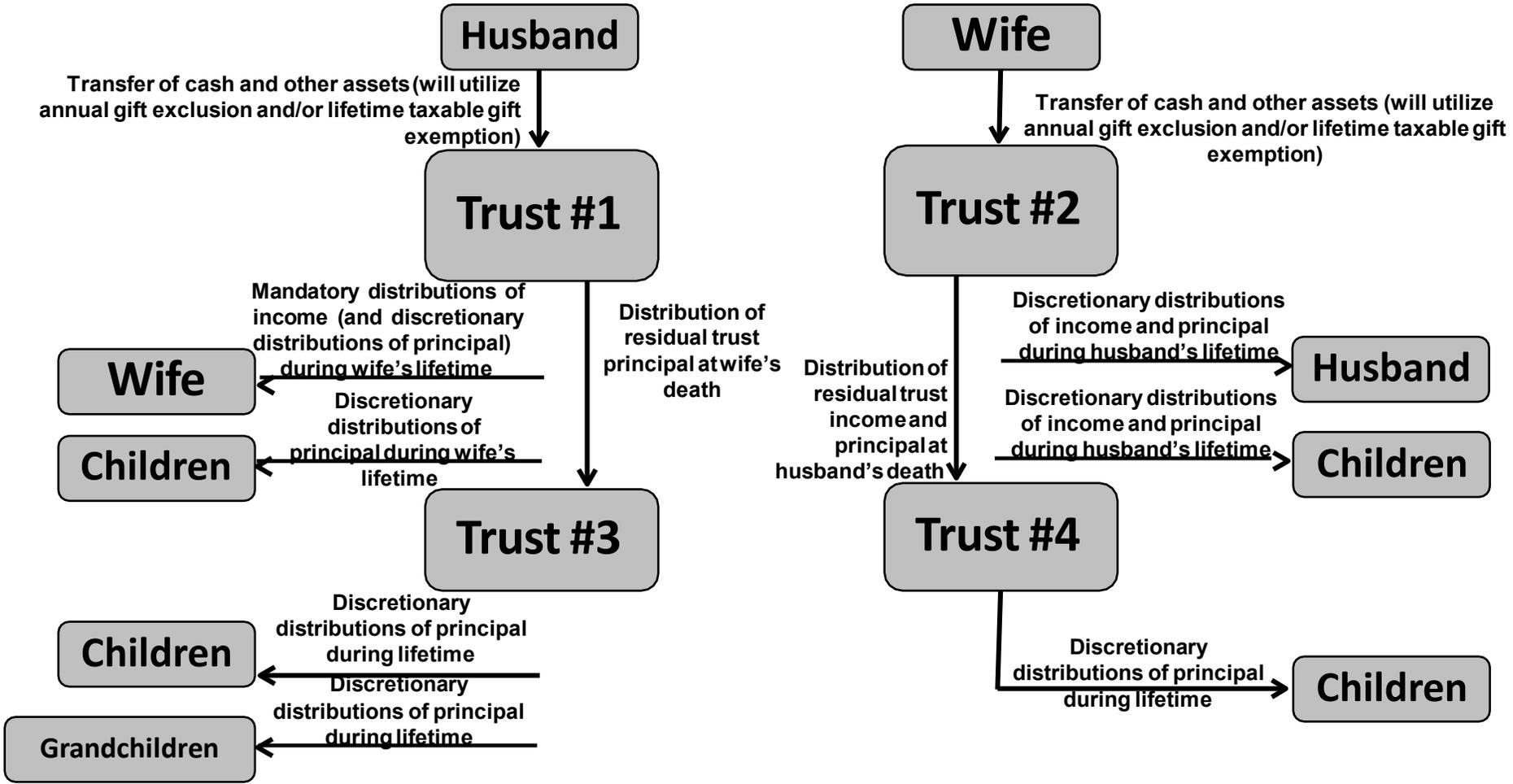
(making them non-reciprocal)

- Fund the trusts with different amounts on different dates;
- Have different independent trustees serve in each trust;
- Allow one spouse to receive distributions currently of income and principal from the trust, while deferring or delaying (i.e., for 3-5 years) the time when the other spouse can participate in distributions from his or her trust;
- Give one spouse a limited power of appointment over the assets in her trust (i.e., to distribute assets in the trust at her death among children, their spouses, other descendants and even charities), but do not give the same powers to the other spouse in his trust;
- Have different beneficiaries in each trust;
- Make descendants current beneficiaries of one trust, but not the other trust;
- Giving one spouse the power to replace or remove trustees in his trust, while not giving the same power to the other spouse over her trust (i.e., perhaps giving that power to the children);
- One SLAT could use a Trust Protector to watch over the trustees and the trust, while the other SLAT may not utilize this concept or have different powers; and/or
- Allow one spouse to be the primary beneficiary of her trust, while treating the other spouse and all descendants as current income and principal beneficiaries.



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Spousal Limited Access Trust (SLAT)



Sale (or gift or both) to IDGT or SLAT

- **DESIGN:** Grantor gifts or sells an asset to an intentionally defective grantor trust (IDGT) or spousal lifetime access trust (SLAT), in exchange for a promissory note if a sale.
 - Grantor makes seed gift to a new trust of at least 10% of the value of the assets being transferred to the trust.
 - Note usually secured by security agreement/pledge plus guaranty of trust beneficiary.
 - Note must bear interest at applicable federal rate for note term.
 - Interest only, balloon permitted? Accrue interest?

Sale (or gift or both) to IDGT or SLAT (cont'd)

- **GRANTOR TRUST:** Trust income taxed to Grantor.
 - Payment of income tax on behalf of the trust is not treated as a gift by the Grantor to the trust (per Rev. Rul. 2004-64), allowing assets to grow inside the trust income tax-free.
 - Any of the following provisions allows the trust to qualify as a grantor trust:
 - Grantor has power to reacquire trust assets by substituting other property of an equivalent value;
 - Grantor has power to control trust investments;
 - Grantor has reversionary interest in the trust greater than 5% of the trust's value;
 - Grantor or Grantor's spouse can receive trust income at the discretion of a non-adverse party; or
 - Grantor can borrow from the trust without adequate interest or adequate security



Sale (or gift or both) to IDGT or SLAT (cont'd)

- **IMPACT:** Installment sale not taxable to the Grantor for federal income tax purposes.
 - Some states (e.g., Pennsylvania) - trust must file tax returns and pay taxes on its income (S corporation stock may be problematic).
 - Since no gain or loss is recognized on Grantor's sale of the assets to the IDGT, Grantor is not required to report the sale on his/her federal income tax return.
 - Also, the Grantor is not taxed separately on the interest payments that he/she receives from the IDGT, and the Grantor will continue to be taxed individually on all income generated by the IDGT as if it did not exist.

Sale (or gift) to IDGT or SLAT (cont'd)

- **MORE IMPACT:** Sale of an interest in a closely-held entity (e.g., LLC, LP, TIC interest in real estate) may attract valuation discounts.
 - Hire a qualified appraiser to value the interest being sold.
 - The purchase agreement might describe the quantity of an asset being sold through the use of a formula expressing that quantity as a dollar amount rather than as a number or percentage of units, e.g., as \$X worth of Newco, LLC membership interests, rather than XX% of Newco, LLC.
 - Recent cases (e.g., *Wandry*) - courts might recognize the effectiveness of such a formula to eliminate any gift if the IRS successfully challenges the valuation and argues that the assets being sold to the trust have a greater value than reported in the sale transaction.

Sale (or gift) to IDGT or SLAT (cont'd)

- **COMPLIANCE:** Gift and sale should be reported on a timely-filed federal gift and GST tax return (Form 709)
 - Grantor can allocate GST exemption to the seed gift to permit the IDGT to qualify for exemption from both the estate and GST tax.
 - Include copies of the executed trust, the gift and sale documentation, the appraisal and other support for the transaction.
 - Filing Form 709 starts the running of the statute of limitations.
 - In subsequent years, the trustee would file Form 1041 for the trust and would allocate all trust income and deductions to the Grantor. The Grantor would report the trust's income on his or her income tax return.
 - Trustee may reimburse the Grantor for income tax paid on behalf of the trust, although any such reimbursement would reduce the transfer tax benefits of the arrangement.

Sale (or gift) to IDGT or SLAT (cont'd)

- **ADVANTAGES:**

- Freezes value of transferred assets in the year of transfer, shifting appreciation out of the Grantor's estate in a low-interest rate environment (i.e., any growth above AFR is out of the estate).
- Note's value is only asset included in the Grantor's estate if the Grantor dies while the note remains unpaid.
 - *Note may be subject to valuation discount.*
- The valuation discount on the trust assets and any income tax paid by the Grantor on trust income save additional transfer taxes.

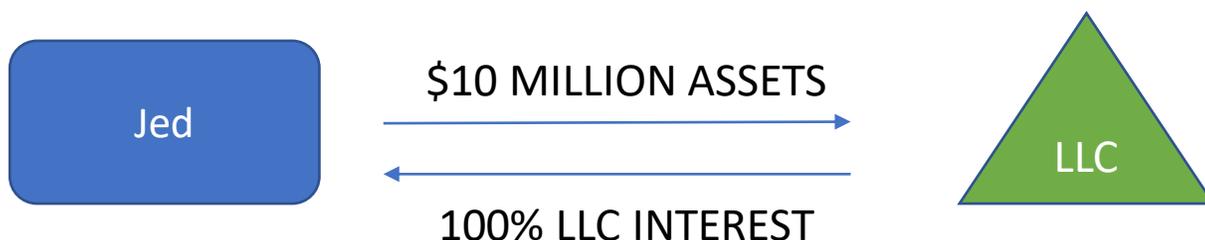
Sale (or gift) to IDGT or SLAT (cont'd)

- **RISKS:**

- Sale-to-IDGT has not been officially approved by Congress, IRS or the courts
- If the Grantor dies during the term of the note, the grantor trust status of the IDGT terminates and the Grantor or the Grantor's estate may have to recognize the deferred gain attributable to the unpaid portion of the principal of the note.
- Sale without gift risks losing ability to use largest exemption in history.
- Deemed gift if Grantor intends to forgive note at outset (Compare *Rev. Rul 77-299, 1977-2 C.B. 343* (deemed gift up front if part of prearranged plan) with *Rev. Rul. 81-264, 1981-2 C.B. 186* (no deemed gift if intent to give arises later)).
- Reciprocal trust, step transaction doctrines (and other IRS weapons) applied!
- Potential changes in tax law!

Sale (or gift) to IDGT or SLAT (cont'd)

- **EXAMPLE:** Jed contributes assets worth \$10 million to an LLC in exchange for an LLC interest.

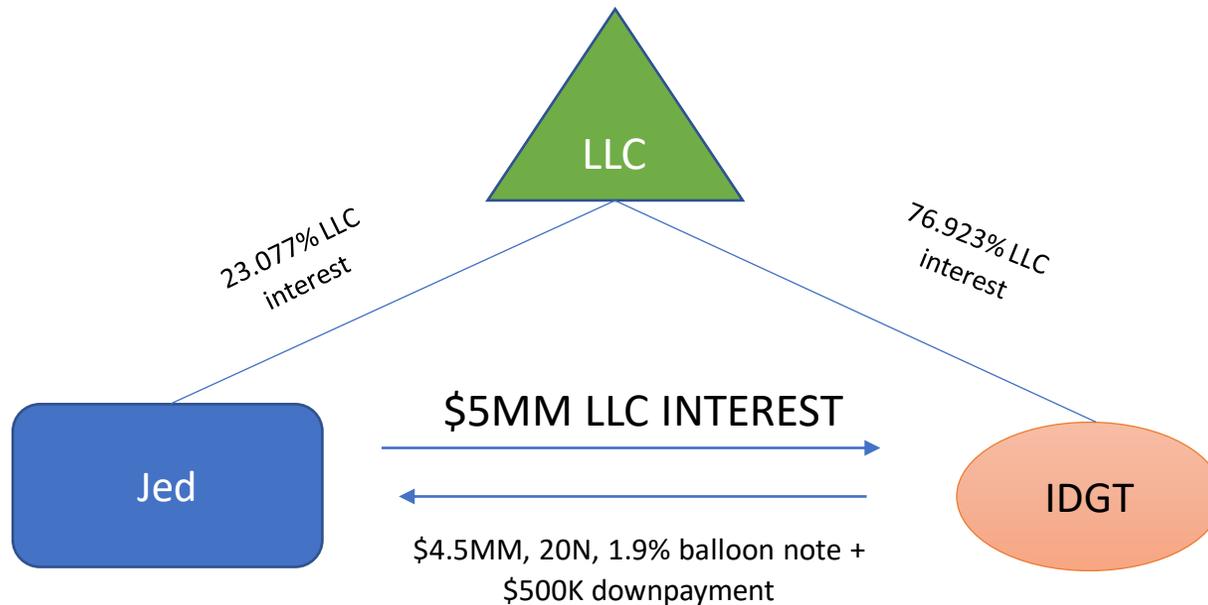


Then, Jed creates an irrevocable grantor trust (IDGT) by contributing/gifting \$500,000 in cash or other assets to IDGT as a seed gift.



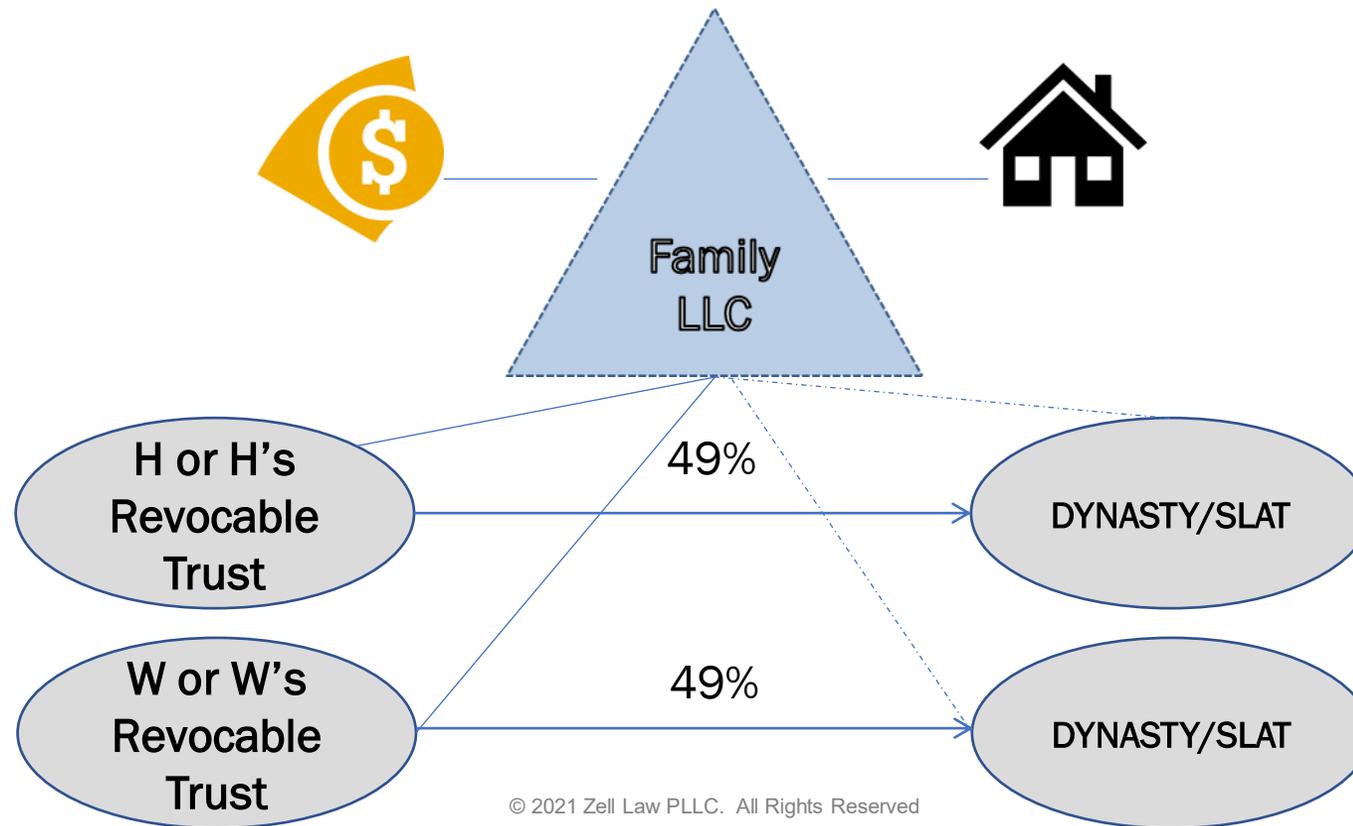
Sale (or gift) to IDGT or SLAT (cont'd)

- EXAMPLE (con'td):** Next, Jed sells \$5 million worth of LLC interest to the IDGT in exchange for \$500,000 downpayment plus a \$4.5 million promissory note payable in 20 years at an annual interest rate of 1.9% (Dec. 2021 long-term AFR). Jed gets an appraisal for a 1% non-controlling, non-managerial interest in the LLC equal to \$65,000 (assuming a 35% combined discount for lack of marketability and lack of control). Based upon the appraisal, Jed sells 76.923% ($\$5,000,000 / \$65,000 * 1\%$) of the LLC to the IDGT. The IDGT grants a security interest in the LLC interest to the Jed and the IDGT beneficiaries guarantee the IDGT's obligations.



Family LLC with Dynasty Trust/2 SLATs

GIFT EXAMPLE: Clients contribute assets worth \$20MM to FLLC. Clients then gift 49% each of FLLC to non-reciprocal Dynasty/SLATs. Assuming a valuation discount of 35%, each gift is valued at \$6.37MM ($\$20\text{MM} \times 49\% \times (1-35\%)$) and lifetime exclusion of that amount is used. Clients pay income tax on income allocated to Dynasty/SLATs. Initial transfer tax savings are \$2.744MM (40% of aggregate discount attributable to both gifts), + 40% of appreciation attributable to 98% + 40% of income tax paid on trust income.



GRAT planning

- Ideal for volatile markets: no loss of exemption if zeroed out
- No basis issue because GRATs only transfer future appreciation, not unrealized gains
- 2-year GRATs are ideal
- Front-loaded GRATs: 90%
- Actively-managed GRATs:
- Buying back assets from depressed GRATs and try again with lower value
- Buying back assets from appreciated GRATs to lock in gains, roll into another GRAT
- Can swap for other securities or a note

GRAT planning (cont'd)

- Use individual stock GRATs: Don't mix stocks or losers will offset winners
 - 2-year GRAT funded with \$10 million, comprised of 10 different stocks of equal values (\$1,000,000 each), and stock #1 produces a return of 1%, stock #2 produces a return of 2%, and so on. The weighted-average return of the portfolio would be 5.5%. If the Section 7520 rate is 5.4% (currently 1.6% for December 2021 and ___ for January 2022), only \$15,533 will be left for the remaindermen.
 - If same stocks are transferred into 10 separate 2-year GRATs, the GRATs will transfer a total of over \$208,034 to the remaindermen-- more than 13 times the amount from a single GRAT with multiple stocks. This return is magnified as the overall rates of return exceed the 7520 rate.
- Disclaimer GRATs: gift to marital trust, disclaimer by spouse to a GRAT. 9 month look-back

GRAT mechanics (cont'd)

- General: value of gift equals the difference between the total value of the property and the value of the interest retained by the Grantor
- Exception - §2702(a)-Value of any interest retained by the transferor or an applicable family member (i.e., the transferor's spouse, an ancestor of the transferor or the transferor's spouse, and the spouse of any such ancestor) is zero; so, total value of property is a gift
- Exception to exception - §2702(a)(2)(B)- if the transferor's retained interest is a “qualified interest,” the value of the retained interest is determined under §7520
 - Includes qualified annuity interest, a qualified unitrust interest, and a qualified remainder interest.
 - GRAT provides the grantor with a qualified annuity interest.
 - A grantor retained unitrust (GRUT) provides the grantor with a qualified unitrust interest.

GRAT mechanics (cont'd)

- Following requirements must be met:
 - the interest must be a qualified annuity or unitrust interest in every respect;
 - a holder's qualified interest must be payable to or for the benefit of the holder for the fixed term and must not be subject to any contingencies other than either the survival of the holder until the commencement (or throughout the term) of his or her interest or the transferor's right to revoke a qualified interest of his or her spouse;
 - distributions may not be made to anyone but the annuitant or unitrust recipient;
 - the term of the interest must be fixed;
 - the term holder's interest may not be commuted; and
 - debt obligations may not be used to satisfy the annuity or unitrust payment obligation.

GRAT mechanics (cont'd)

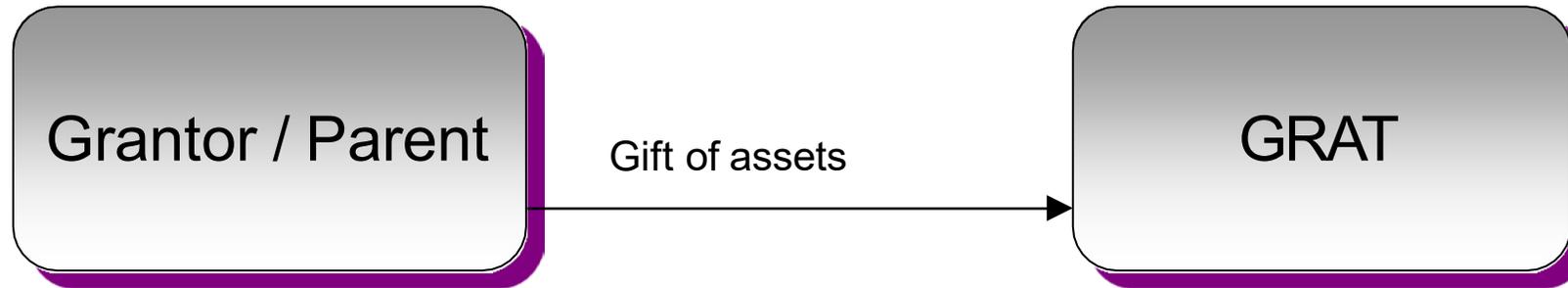
- GRAT vs. GRUT
 - GRAT produces better result if expected return is greater than §7520 rate.
 - But if the value of the GRAT or GRUT drops during the first year but increases significantly during the second year, the GRUT may produce a better result than a GRAT.
 - Example-Jean creates a 2-year \$1 million GRAT to pay herself \$537,000 at the end of each year. Jean also creates a two-year \$1 million GRUT to pay herself at the end of each year 90% of the value of the trust at year-end. Each trust drops in value to \$500,000 at the end of the first year.
 - \$500K in the GRAT would be paid at year-end to Jean in satisfaction of her \$537,000 annuity. Nothing will pass from the GRAT to the remainder beneficiaries.
 - GRUT will pay Jean at the end of Y1 90% of \$500,000, or \$450,000, leaving \$50,000 in the GRUT. Next year, unless the GRUT drops to zero, 90% of the year-end value will be paid to Jean and 10% will be paid to the remainder beneficiaries.

GRAT compared to GRUTs

- GRAT produces better result if expected return is greater than §7520 rate.
- But if the value of the GRAT or GRUT drops during the first year, then increases significantly during the second year, the GRUT may produce a better result than a GRAT.
- Example-Jean creates a 2-year \$1 million GRAT to pay herself \$537,000 at the end of each year. Jean also creates a two-year \$1 million GRUT to pay herself at the end of each year 90% of the value of the trust at year-end. Each trust drops in value to \$500,000 at the end of the first year.
 - \$500K in the GRAT would be paid at year-end to Jean in satisfaction of her \$537,000 annuity. Nothing will pass from the GRAT to the remainder beneficiaries.
 - GRUT will pay Jean at the end of Y1 90% of \$500,000, or \$450,000, leaving \$50,000 in the GRUT. Next year, unless the GRUT drops to zero, 90% of the year-end value will be paid to Jean and 10% will be paid to the remainder beneficiaries.

Grantor Retained Annuity Trust Illustrated

STEP ONE: GIFT OF ASSETS

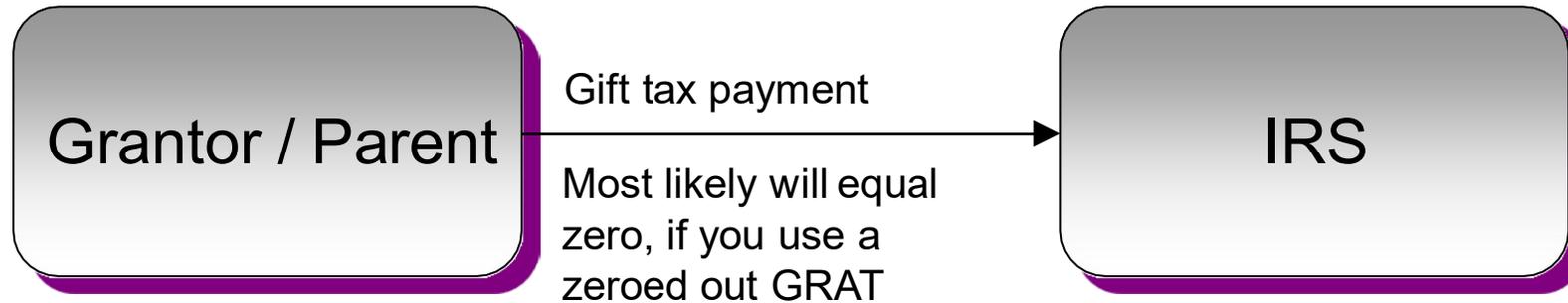


For gift tax purposes, the initial gift is based upon a calculation of the present value of an annuity stream payable by the GRAT to the grantor.

All growth in excess of the IRC §7520 rate inures to the beneficiaries, effectively freezing growth of assets to the IRC §7520 rate. In December 2021, the §7520 rate is 1.6% and January 2022 is ____%.

Grantor Retained Annuity Trust

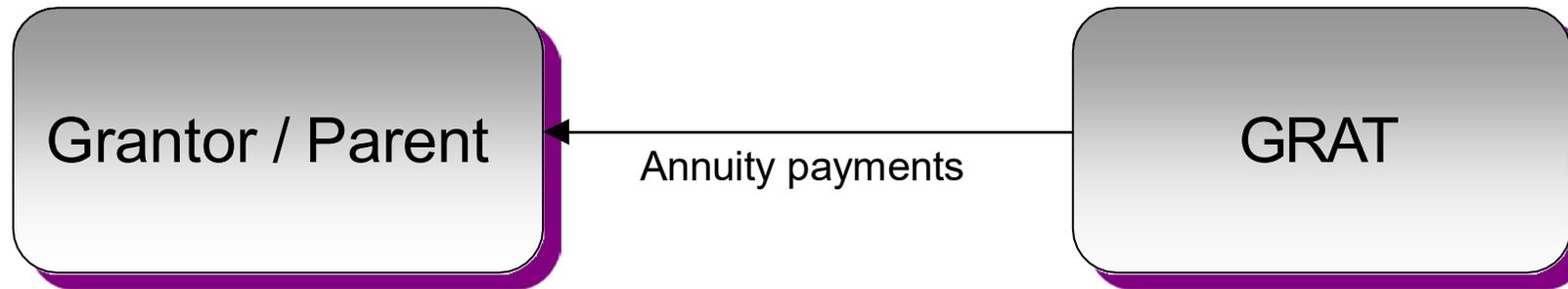
STEP TWO: PAYMENT OF GIFT TAX



- The amount of the taxable gift is the value of the property transferred to the trust minus the present value of the annuity interest payable to the Grantor.
- In valuing the lead interest, the IRS assumes that the trust assets produce a return equal to the IRC §7520 rate, effectively freeing the value at that level.

Grantor Retained Annuity Trust

STEP THREE: ANNUITY PAYMENTS



The GRAT must provide for payment of an annuity to the grantor not less frequently than annually.

If cash flow is insufficient to satisfy the GRAT annuity payments, in-kind distributions can be made to the grantor to satisfy the annuity payments. These in-kind distributions could be contributed to new GRATs to avoid estate inclusion of the in-kind distributions.

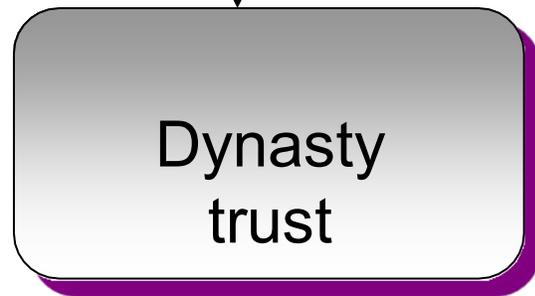
Grantor Retained Annuity Trust

STEP FOUR: PAYMENT TO BENEFICIARIES



At conclusion of GRAT term, remaining assets are transferred to children or Dynasty Trust for their benefit.

At this point, no further tax is imposed (except on income).



The Dynasty trust can be structured to make distributions of income and principal to children and future generations as the Grantor desires.

Grantor Retained Annuity Trusts

2021 Legislative Proposals – NOT IN HOUSE BILL

- GRATs would be limited to a minimum 10-year term
- Valuation discounts would be disallowed on non-business assets
- GRATs must have a remainder value of at least the greater of \$500,000 or 25 percent of the value of property contributed to the GRAT but not more than the fair market value of the gift property in trust
- Grantor trusts (including GRATs and IDGTs) created, or contributions made to grantor trusts, after the date of enactment would be subject to estate tax at the grantor's death, and if distributions were made from the trust during the lifetime of the grantor, or grantor trust status were turned off, the grantor would be subject to gift tax
- Under STEP Act, effective January 1, 2021, certain events such as gifts, death, termination of grantor trust status, etc., or where assets are no longer included in the grantor's estate for estate tax purposes, would trigger recognition of gain and loss and be subject to income tax

Type of Calculation:	Term
Transfer Date:	8/2021
\$7520 Rate:	1.20%
Income Earned by Trust:	0.00%
Term:	2
Total Number of Payments:	2
Annual Growth of Principal:	20.00%
Pre-discounted FMV:	\$10,000,000
Discounted FMV:	\$10,000,000
Optimized:	Yes
Optimized Payout:	50.9009467000%
Exhaustion Method:	IRS
Payment Period:	Annual
Payment Timing:	End
Distribute Principal in Kind:	Yes
Vary Annuity Payments?	No
Is Transfer To or For the Benefit of a Member of the Transferor's Family?	Yes
Is Interest in Trust Retained by Transferor or Applicable Family Member?	Yes
With Reversion?	No

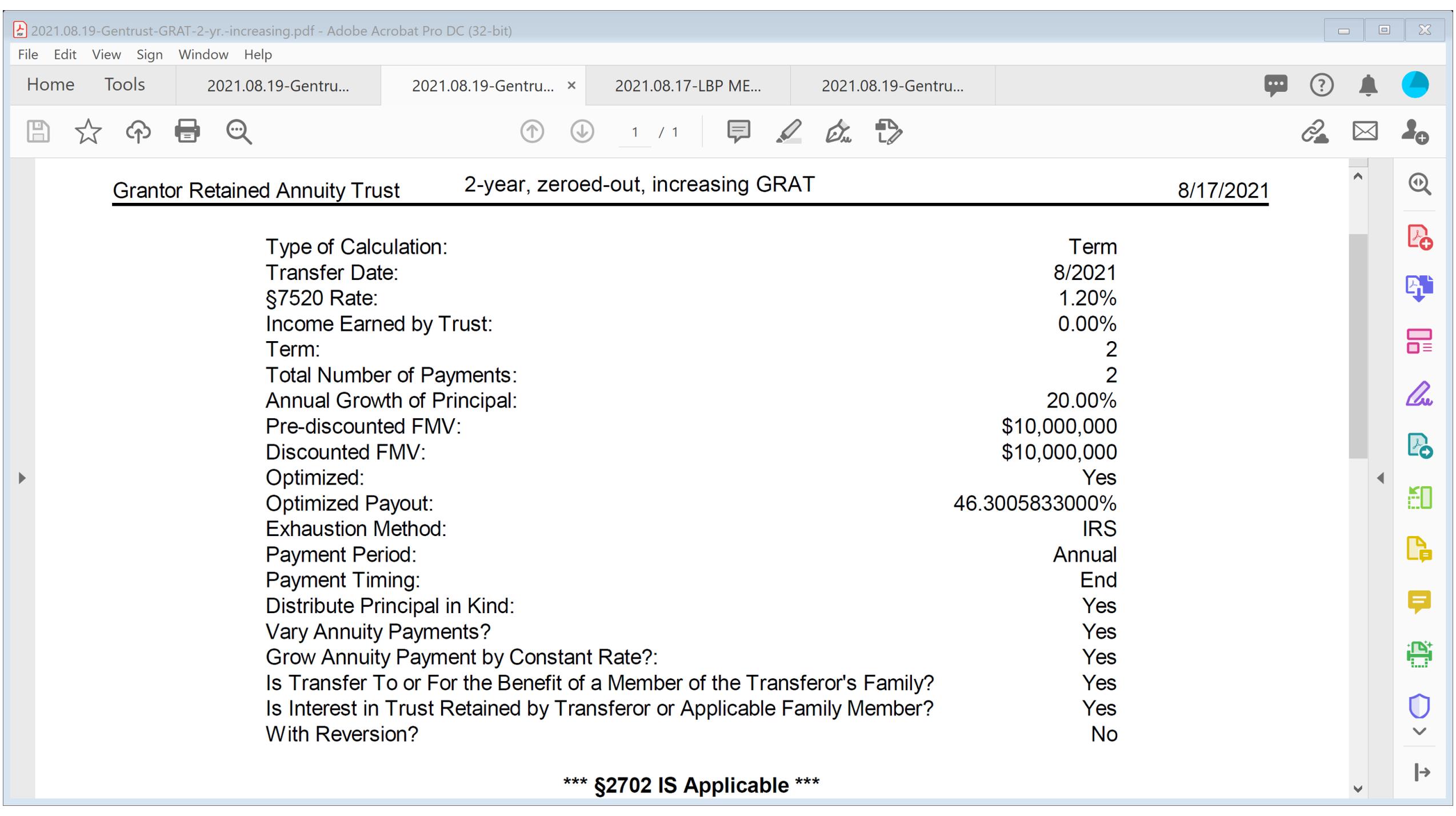
*** §2702 IS Applicable ***

*** §2702 IS Applicable ***

Base Term Certain Annuity Factor:	1.9646
Frequency Adjustment Factor:	1.0000
Annual Annuity Payout:	\$5,090,094.67
Initial Amount of Payment Per Period:	\$5,090,094.67
Value of Term Certain Annuity Interest:	\$9,999,999.99
Value of Grantor's Retained Interest:	\$9,999,999.99
(1) Taxable Gift (Based on Term Interest):	\$0.01

Economic Schedule

<u>Year</u>	<u>Beginning Principal</u>	<u>20.00% Growth</u>	<u>0.00% Annual Income</u>	<u>Required Payments</u>	<u>Distributed Discount</u>	<u>Remainder</u>
1	\$10,000,000.00	\$2,000,000.00	\$0.00	\$5,090,094.67	\$0.00	\$6,909,905.33
2	\$6,909,905.33	\$1,381,981.07	\$0.00	\$5,090,094.67	\$0.00	\$3,201,791.73
Summary	\$10,000,000.00	\$3,381,981.07	\$0.00	\$10,180,189.34	\$0.00	\$3,201,791.73



Grantor Retained Annuity Trust 2-year, zeroed-out, increasing GRAT 8/17/2021

Type of Calculation:	Term
Transfer Date:	8/2021
§7520 Rate:	1.20%
Income Earned by Trust:	0.00%
Term:	2
Total Number of Payments:	2
Annual Growth of Principal:	20.00%
Pre-discounted FMV:	\$10,000,000
Discounted FMV:	\$10,000,000
Optimized:	Yes
Optimized Payout:	46.3005833000%
Exhaustion Method:	IRS
Payment Period:	Annual
Payment Timing:	End
Distribute Principal in Kind:	Yes
Vary Annuity Payments?	Yes
Grow Annuity Payment by Constant Rate?:	Yes
Is Transfer To or For the Benefit of a Member of the Transferor's Family?	Yes
Is Interest in Trust Retained by Transferor or Applicable Family Member?	Yes
With Reversion?	No

*** §2702 IS Applicable ***

***** §2702 IS Applicable *****

Base Term Certain Annuity Factor:	2.1598
Frequency Adjustment Factor:	1.0000
Initial Annual Annuity Payout:	\$4,630,058.33
Initial Amount of Payment Per Period:	\$4,630,058.33
Annual Annuity Payment Growth:	19.99%
Value of Term Certain Annuity Interest:	\$9,999,999.98
Value of Grantor's Retained Interest:	\$9,999,999.98
(1) Taxable Gift (Based on Term Interest):	\$0.02

Varying Annuity Payments

<u>Year</u>	<u>Percentage Payouts</u>	<u>Payment</u>
1	46.3005833000%	\$4,630,058.33
2	55.5560699000%	\$5,555,606.99

Economic Schedule

<u>Year</u>	<u>Beginning Principal</u>	<u>20.00% Growth</u>	<u>0.00% Annual Income</u>	<u>Required Payments</u>	<u>Distributed Discount</u>	<u>Remainder</u>
1	\$10,000,000.00	\$2,000,000.00	\$0.00	\$4,630,058.33	\$0.00	\$7,369,941.67
2	\$7,369,941.67	\$1,473,988.33	\$0.00	\$5,555,606.99	\$0.00	\$3,288,323.01
Summary	\$10,000,000.00	\$3,473,988.33	\$0.00	\$10,185,665.32	\$0.00	\$3,288,323.01

Income Tax Treatment of Life Insurance (1 of 6)

- **In general**
 - There is no income tax on death proceeds.
- **Transfer for value exception**
 - There may be income tax on proceeds if policy is transferred for value.
 - **Except** for transfers to:
 - The insured.
 - Partner of insured.
 - Partnership/corporation where insured is partner/shareholder or officer.
 - Gift of policy.

Income Tax Treatment of Life Insurance (2 of 6)

- **Settlement Options**

- Lump Sum Benefit

- Theoretically, no income tax, although there will be tax on the earnings from the time of death until distribution.

- Annuity

- Income taxation on the interest portion of an annuity.

- **Policy Dividends**

- Treated as a return of basis

- If the policy is surrendered, the cash received less the basis is taxable.

Income Tax Treatment of Life Insurance (3 of 6)

- **Loans**

- Generally, no income tax consequences.
- Exception – if the policy lapses and there is an outstanding loan.
 - Ordinary income tax on the outstanding loan in excess of basis.
- Exception – MECs.
 - Investments disguised as insurance policies.
 - Causes LIFO tax inclusion for loans.
 - Must fail 7-pay test to be a MEC.

Income Tax Treatment of Life Insurance (4 of 6)

- **Policy Exchanges Under Section 1035.**
 - Life insurance policy can be exchanged for another insurance policy, an endowment contract, or an annuity tax free.
 - An annuity cannot be exchanged for an insurance policy tax free.

Income Tax Treatment of Life Insurance (5 of 6)

	Exchange From:	
Exchange To:	Life Insurance	Annuity
Life Insurance	Nontaxable Event	Taxable Event
Annuity	Nontaxable Event	Nontaxable Event

Income Tax Treatment of Life Insurance (6 of 6)

- Accelerated Death Benefits
 - Viatical settlements are income tax free.
 - Owner of policy must be chronically ill or terminally ill.
- Chronically Ill
 - Certified by doctor as being unable to perform at least two of the six activities of daily living (eating, toileting, transferring, bathing, dressing, continence).
- Terminally Ill
 - Certification from a doctor that the insured is expected to die from illness within 24 months.
- No income tax consequences even if miraculous recovery.

Gift Tax Treatment of Life Insurance (1 of 2)

- **Changing the beneficiary** on the life insurance policy.
 - No gift tax consequences.
- **Outright gift** of a life insurance policy
 - **Premium pay status**
 - If premiums are being paid by donor, then the gift tax value is the sum of the policy's interpolated terminal reserve plus unearned premiums.
 - **Paid up policy**
 - If paid up where premiums are no longer necessary, then the gift tax value is the replacement cost of the policy.

Gift Tax Treatment of Life Insurance (2 of 2)

- **Gifts of premiums**
 - The gift is equal to the cash transferred
 - If paid to a trust – need a Crummey provision to get annual exclusion, which may be limited by 5/5 lapsing power if multiple beneficiaries
- **Gifts of life insurance to charities**
 - Income tax deduction equal to the lesser of the adjusted basis or FMV
 - AGI Limitation – 60% / 30%

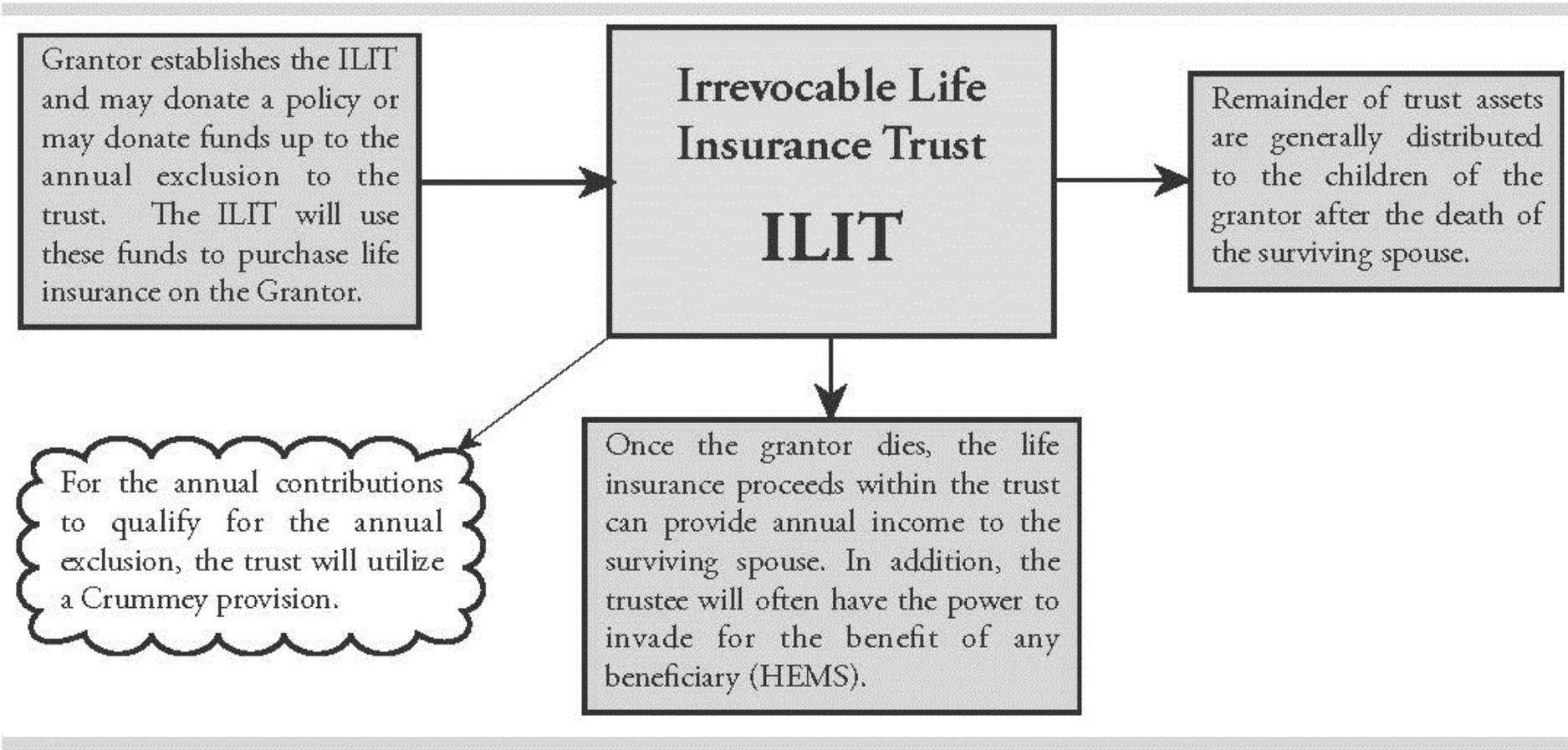
Estate Tax Treatment of Life Insurance

- **IRC Section 2033 – Life insurance on someone else’s life**
 - The interpolated terminal reserve plus any unearned premium is included in the gross estate of the owner/decedent.
 - Life insurance on the insured/decedent’s life
 - The death benefit is included in the gross estate.
- **IRC Section 2035 – The three-year rule**
 - Policies owned by the decedent on his own life that are assigned within 3 years of death are included in the decedent’s gross estate.
- **IRC Section 2042 – Incidents of ownership**

Creation of a Life Insurance Trust (ILIT)

- Trust holds life insurance policy
- Utilizing the annual exclusion
 - Crummey provision
- Avoid requiring the trust to pay proceeds to estate for taxes or administration expenses because it causes inclusion in the gross estate.
- In order to provide liquidity:
 - Allow trust to purchase assets of the estate.
 - Allow trust to loan money to the estate.
- Not included in the gross estate of the insured if there is no incidence of ownership.

Creation of a Life Insurance Trust (ILIT)



ZELL LAW

Business | Estate | Tax | Fiduciary

Impact of Proposed W&M Bill on ILITs (1 of 3)

- For any portion of a trust with respect to which the **grantor is the deemed owner**: (1) the gross estate of a deceased deemed owner of such portion includes all assets attributable to that portion at the time of the deemed owner's death; (2) any distribution (other than to a deemed owner or the deemed owner's spouse) from such portion to one or more beneficiaries during the life of the deemed owner of such portion, other than in discharge of an obligation of the deemed owner, is treated as a transfer by gift for gift tax purposes; and (3) if during life the deemed owner ceases to be treated as the deemed owner of such portion (i.e., turn off grantor trust status), all assets attributable to such portion are treated as having been transferred by gift for gift tax purposes at such time.
- Effective for (1) trusts created on or after the date of enactment and (2) any portion of a trust established before the date of enactment that is attributable to a contribution made on or after such date!
- If enacted, this would eliminate the ability to fund ILITs treated as grantor trusts with annual exclusion gifts or have premiums paid from income.

Impact of Proposed W&M Bill on ILITs (2 of 3)

- **Most ILITs are treated as grantor trusts:**
 - Trustee may pay premiums from income without consent of an adverse party – Sec. 677(a)(3)
 - Spousal rights provisions under Sec. 677(a)(1)
 - Substitution power and other administrative powers – Sec. 675 powers
- **If enacted and further gifts are required after date of enactment to pay premiums:**
 - Reduce face amount without endangering policy
 - Create supplemental, non-grantor trust to receive future gifts and purchase new policy to make up any shortfall
 - Make additional gifts to ILIT before date of enactment; can use premium deposit account to pay future premiums
 - Make market rate loans (?)
 - Use commercial premium finance
 - Convert to non-grantor trust post-enactment; toggle off existing grantor trusts or decant into non-grantor trust

Impact of Proposed W&M Bill on ILITs (3 of 3)

- **If W&M legislation is enacted, avoid grantor trust status on newly created ILITs**
 - Add provision in new ILIT that permits only trust principal (not income) to be applied to pay premiums on life of grantor or spouse
 - Require consent of adverse party (i.e., non-spouse beneficiary or person having income interest in trust) before applying trust income to pay premiums on life of grantor or spouse
 - Design trust so trustee can apply for life insurance on the life of someone other than the grantor or spouse
- **Gifts to properly drafted non-grantor trusts drafted and executed after date of enactment will not cause inclusion in grantor's estate**

Section 2702 Generally

- **§2702 general rule** – if §2702 applies, interest retained by transferor or applicable family member is valued at zero so that the gift tax value of what was transferred = 100% FMV of property
- **Exception** – value of transferor's retained interest is subtracted from the FMV to determine gift tax value of transferred interest
- **Example** - Adele, age 35, transfers \$1,000,000 to a trust, retaining the right to income for 20 years or until Adele's earlier death with a reversion of the trust principal to Adele's estate. If the applicable §7520 rate is 2.0%, Adele's retained interest has a value of \$368,487.51.26. If the transfer qualifies for an exception to §2702, Adele's gift tax is payable on \$631,512.49 (\$1,000,000 – \$368,487.51). If, however, §2702 applies, Adele's retained interest is valued at zero and gift tax is payable on the entire \$1,000,000.

Exceptions to Section 2702

- Incomplete gifts
- **Personal residence trusts**
- **Charitable remainder trusts**
- **Charitable lead trusts**
- Assignment of remainder interests in discretionary trust with permissible income distributions by independent trustee
- Certain marital property settlements incident to a divorce
- Qualified annuity, unitrust and remainder interests (including GRATs)

Personal Residence Trusts

- “Regular” personal residence trusts – transfer of a residence to be used as a “personal residence,” which is either: (1) the principal residence of the term holder (within the meaning of former §1034, relating to the nonrecognition of gain upon sale of a principal residence); (2) one other residence of the term holder (within the meaning of §280A(d)(1) — without regard to §280A(d)(2) — relating to property that is used in part as a residence); or (3) an undivided fractional interest in either of the foregoing.
 - Includes shares of stock in a coop and vacation homes.
 - May include house, guest house, barn, but not tangible personal property.
 - May be mortgaged.
 - But, *property may not be sold during term.*

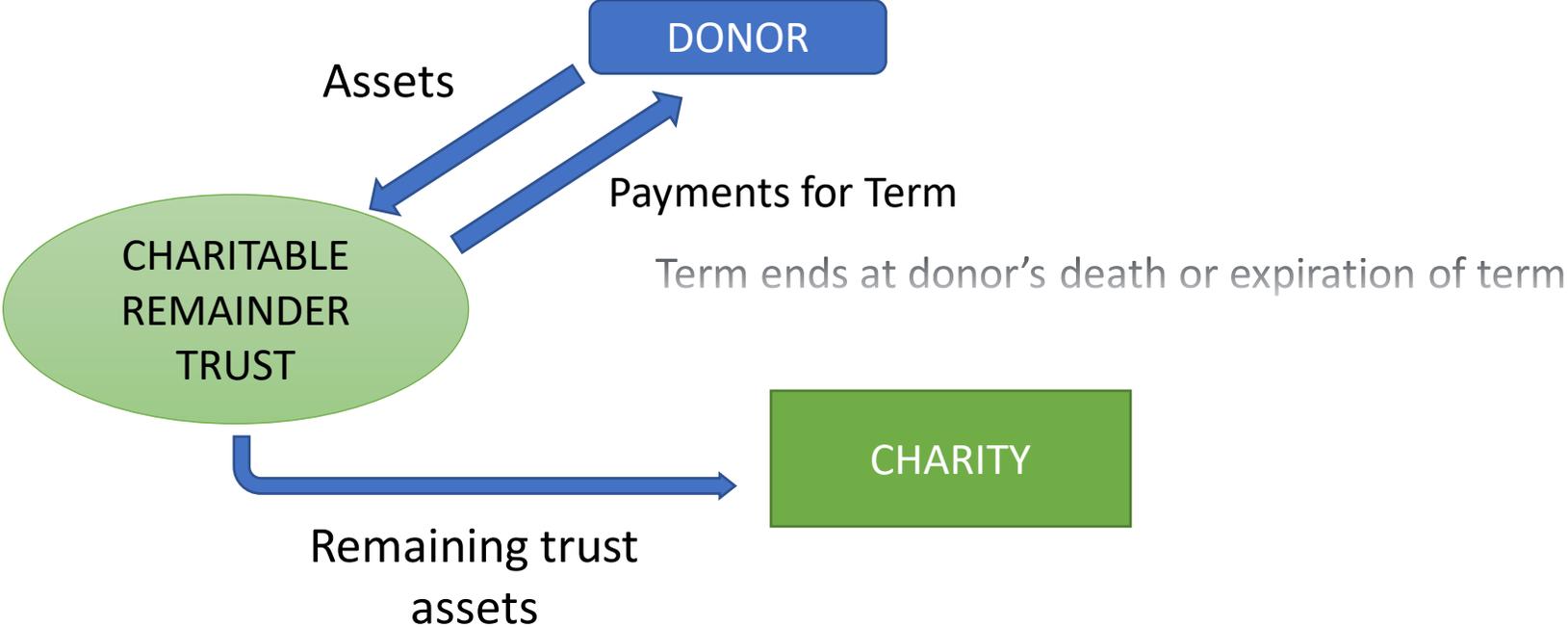
Qualified Personal Residence Trusts

- All income of trust must be distributed to grantor at least annually during term.
- Principal can only be distributed to grantor during term.
- Trust can own only one personal residence during term.
 - May permit additions of cash during term for trust expenses (including mortgage payments) or improvements, reasonably expected to be paid within 6 months
 - Additional cash may be added to purchase or replace the residence within 3 months of adding cash
- Unlike “regular” PRT, QPRT may sell the property, but not to grantor, grantor’s spouse or entity controlled by grantor during term or while trust is a grantor trust
- Term holder’s interest cannot be prepaid (i.e., commuted).
- Must convert into GRAT or must be distributed to grantor if trust ceases to qualify as QPRT.

Regular PRT vs. Qualified Personal Residence Trusts

- Unless grantor enters into “joint purchase”, QPRTs usually are preferred
 - Remainder holder may want a **joint purchase** with grantor if the residence's value at the end of the term (i.e., life estate) exceeds the value of what he or she would hold if he or she had made a different investment with the funds used to purchase the remainder interest.
 - QPRT can own more assets than a PRT.
 - QPRT can sell personal residence; PRT cannot

Charitable Remainder Trusts



Charitable Remainder Trusts

- Unitrust or annuity payable to income beneficiary for life or term
- Remainder payable to charity
- Pooled income fund = charitable remainder also serves as trustee
- Less important as estate tax rates drop, exemptions increase or tax is repealed
- Favorable tax consequences:
 - Income tax deduction to grantor for PV of remainder, limited to 20% or 30% of AGI
 - No tax on sale of appreciated property by CRT
 - Income is tax-exempt, unless UBI
 - Estate and gift tax savings



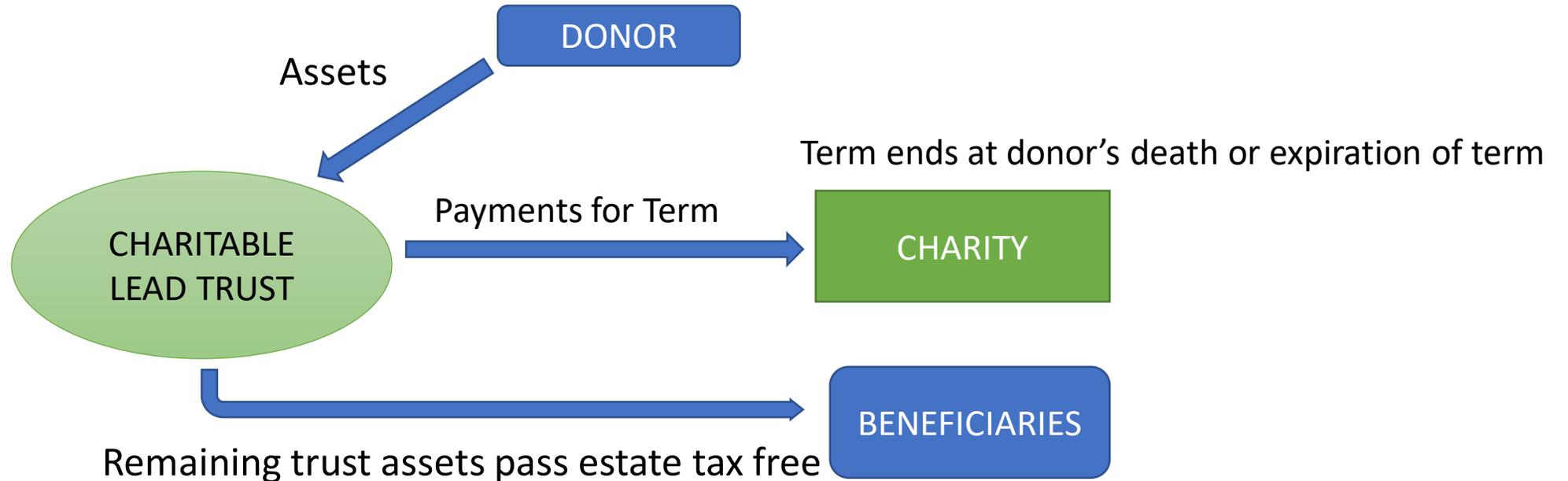
Charitable Remainder Trusts

- **CRT requirements:**
 - Not less than 5% nor more than 50% of net FMV of assets must be paid to non-charitable beneficiaries
 - Charity's remainder interest must be >10% of assets transferred to trust
- **CRUTs are revalued annually**
 - CRATs only can receive an initial contribution
- **CRUT variations:**
 - Straight CRUT
 - NIM-CRUT
 - Flip-CRUT

Charitable Remainder Trusts

- **Other issues/benefits:**
 - QTIPs with charitable remainders
 - Spousal waiver is critical
 - Loss of tax exemption if UBI
 - Use to stretch inherited IRA

Charitable Lead Trusts



Charitable Lead Trusts

- Unitrust or annuity payable to charity for fixed term
- Low interest rates indicate CLATs
- Annuity is (1) guaranteed and (2) fixed % of fair market value
- Income tax deduction only if treated as grantor trust

Charitable Lead Trusts

- A CLT permits an estate owner to:
 - Transfer assets to heirs and receive significant estate or gift tax deductions
 - Reduce exposure to income tax by providing income to a charitable organization

Charitable Lead Trusts

- **Donor:**
 - Makes a gift of property to irrevocable trust
 - Charity is income recipient and receives either an annual fixed % of the net fair market value of trust assets or an annual fixed amount for a certain period of time or the life of the donor or another individual
 - Receives either a gift tax charitable deduction or estate tax deduction depending upon whether trust is created during lifetime or at death of donor

Charitable Lead Trusts

- **Key benefits:**
 - Permits transfer of assets to heirs with significantly reduced estate or gift taxes
 - Can reduce income taxes
 - Flexible planning tool to zero out estate tax
 - Can create delayed inheritance/retirement benefit for heirs

Charitable Lead Trusts

- **Other benefits:**
 - Allows excess return on investment within trust to go to heirs tax-free
 - May make multiple gifts to a CLAT
 - Provides long lasting value to charity

Legislative Process

- **House bill**
 - Ways and Means Committee
 - Budget Committee
 - Rules Committee
 - Floor
- **Senate bill**
 - Finance Committee
 - Budget Committee
 - Floor
- **Conference**
- **White House**

Evolution of Tax Legislation in 2021

- Sanders and Van Hollen Bills (2/2021, 4/2021)
- Biden Proposals (5/2021)
- House Ways & Means Committee Tax Proposals (9/13/2021)
- Senate Finance Committee Proposals (10/16/2021)
- House Budget Committee – Reconciliation (10/28/2021)
- Manager’s mark-up (11/3/2021)
- House passes H.R. 5736 – Build Back Better Act (11/19/2021)

Sanders & Van Hollen Proposals:



- “Uncouples” the estate and gift tax exemption amounts and lowers them to \$3,500,000 and \$1,000,000 respectively
- Stops indexing exemptions and exclusions for inflation
- Increases estate tax rate based on the size of the estate: \$3.5M to \$10M - 45%; \$10M to \$50M - 50%; \$50M to \$1B - 55%; >\$1B - 65%
- Donors limited to just two exclusion gifts annually when the gift is made to a trust or is a gift of certain “flow through” assets
- Allows a \$10,000 per-donee annual gift tax exclusion, subject to a \$20,000 per-donor cap
- Prohibits a step-up in basis for assets held in grantor trusts that are not included in the grantor’s gross estate
- Imposes a 50-year limit on generation-skipping trusts (also known as dynasty trusts or GST trusts)
- Imposes limitations on minority interest discounts when valuing certain transfers of non-business assets (for example, certain interests in closely held entities) for gift and estate tax purposes
- Imposes a 10-year required minimum term for GRATs
- Adds NEW Chapter 16 to the Code with rules targeting the gift, estate, and generation-skipping transfer taxation of grantor trusts

STEP Act

(Van Hollen and Sanders – retroactive to 1/1/2021)

- Property transferred by gift to a **nongrantor** trust or transfers at **death**, would be **deemed to have been sold** to the transferee for the property's fair market value on the date of transfer.
 - The transferee would owe income tax any capital gain associated with the deemed sale.
 - Exclusion for up to \$1 million of unrealized capital gains, along with an additional \$250,000 (\$500,000 if married) exclusion for personal residences; transfers to spouses are excluded
- Property that is held by nongrantor trusts will have a **deemed sale every 21 years**
 - Funded nongrantor trusts in existence prior to the effective date of the STEP Act will have their first forced deemed sale on December 31, 2026, and every 21 years thereafter.
- Large trusts will be required to provide the IRS with annual accountings that include balance sheet, income statements, trustee, grantor and beneficiary information
- **For grantor trusts**, deemed sale of the property occurs when the property is transferred out of the trust to another person, when the grantor dies or when trust is no longer a grantor trust



Biden's Green Book (5/28/2021)



- No reduction in estate/gift/GST tax exemptions
- Increases income tax rates on individuals and corporations
 - Individual rates restored to 39.6%, but capital gains over \$1 million also would be taxed at highest ordinary rate
- Tax basis step-up at death retained BUT...
 - ***Unrealized gains on capital assets would be subject to income tax either upon a gift or at death***
 - Assumed that \$1,000,000 aggregate exclusion would apply to gifts and transfers at death, but not clear
 - Transfers at death to charities and U.S. spouses would also generally be excluded from taxation

House Ways & Means Committee Tax Proposals - Overview

Key Estate Planning proposals:

- Accelerates reduction of estate/gift/GST exemptions
- Includes future grantor trust assets in taxable estate & taxes sales to grantor trusts
- Eliminates valuation discounts on entity interests that own non-business assets

House Ways & Means Committee Tax Proposals - Overview

Key Individual Changes

- Create a new 3% surtax on “wealthy” individuals and non-grantor trusts
- Expand the Net Investment Income Tax (NIIT) to cover business income
- Increase the top ordinary income tax rate to 46.4%
 - 39.6% top individual tax bracket + 3.8% NIIT + 3% surtax



House Ways & Means Committee Tax Proposals - Overview

Key Retirement plan changes

- Retirement Plan Contribution Limits - \$10MM limit
- Accelerate Minimum Required Distributions for applicable taxpayers with more than \$10MM in retirement
- Limits on Rollovers to Roth IRAs
- Expands Prohibited Transactions applicable to IRAs – “bad” investments

Senate Finance Committee Proposals

- 15% minimum tax for corporations – applies to public companies that report more than \$1 billion in profits to shareholders
- Billionaire tax - Tradable assets (assets like stocks that are easily valued on an annual basis) owned by billionaires will be marked to market each year.
 - Deferral charge on gains from assets like real estate
 - Highly controversial – would tax gains before the assets are sold

Build Back Better Act – House Compromise

- **EXCLUDES:** W&M proposed tax rate increases (corporate and individual), except new surtax (see below); *all estate & gift tax changes* (including grantor trust changes and valuation discount rules)
- **INCLUDES:**
 - 15% minimum tax for public corporations with financial statement income > \$1 billion
 - 1% excise tax on public companies that repurchase their stock
 - Expansion of 3.8% NII tax to active trade or business income
 - 5% surtax on AGI >\$10MM; additional 3% surtax on AGI > \$25MM
 - Retirement plan limits (>\$10MM prohibited; new RMD)
 - Limits QSBS exclusion retroactive to 9/13/2021
 - SALT relief (\$80,000 from \$10,000 until 2031)
 - Various international inbound and outbound provisions

The Future

- **Evenly divided Congress** (221 D -211 R-House; 50 D-50 R Senate with VP as tie-breaker) has led to increased moderation. Sen. Manchin (D-WV) holds cards.
- **Priorities:** COVID-19 relief and focus, *infrastructure*, immigration reform, voting rights reform, social justice issues.
- **2022 Midterm elections** increase the Dem's sense of urgency.
- **Budget reconciliation** may be the only way to pass legislation, but:
 - Only once per year
 - No filibuster in Senate, but unlimited floor amendments allowed
 - Very complicated and unwieldy
- Additional tax legislation unlikely if not passed in 2021

Retroactivity is possible

- **IMPACT:** Unified credit determined at end of year; if change is made retroactive, gift tax could be owed if credit is reduced!
- **LEGALITY:**
 - *United States v. Carlton*, 512 U.S. 26 (1994) - “customary Congressional practice”; but cannot be unlimited
 - Dep. Asst. Sec. Treasury, Tax Policy, Mark Mazur – Biden administration “not actively considering retroactive legislation
- **POSSIBLE SOLUTIONS:**
 - Formula gift up to available exclusion amount
 - Gifts to QTIP trust – may include disclaimer by spouse
 - Gifts to trust that disclaims assets that revert back to donor
 - Sell assets to delay gift by forgiving promissory note
 - Rescind gift later in same tax year due to mistake of law

Formula gift up to exclusion amount

- **GOAL:** Assign/transfer amount or fractional share equal to remaining gift tax exemption, taking into consideration *reduction* (not increases) in exemption as of the date of the gift.
- **ISSUES:**
 - Similar to *Wandry* clause, but based on Congressional action, not IRS.
 - *Comm'r v. Procter*, 142 F.2d 824 (4th Cir. 1944), *cert. denied* 323 U.S. 756 (1944) (1994) – if deemed a condition subsequent, void as it violates public policy
- **POSSIBLE SOLUTIONS:**
 - Formula *allocation* approach may work better than formula *transfer*
 - Part gift, part sale – Purchase price = FMV assets (as finally determined for gift tax purposes), reduced by finally determined exemption as of date of sale (gift portion)
 - Full gift - Donor still owns amount of exemption reduced retroactively

Transfer to Inter Vivos QTIP Trust

- **DESIGN:** Donor has to be comfortable with spouse being SOLE beneficiary of trust. QTIP election can be delayed until following October 15, donor is in control of that decision.
- **ISSUES:**
 - Must satisfy QTIP requirements: mandatory net income, spouse has ability to make illiquid assets liquid, principal distributed to spouse only
 - Divorce possibility only allows principal or limited power of appointment to be terminated, not income
 - *Clayton* uncertainty (applies for estate tax, not gift tax)
- **POSSIBLE SOLUTIONS:**
 - Add a disclaimer so donee spouse can pass assets to trust for descendants – must be exercised within 9 months and cannot accept any benefits; formula allocation permitted

Rescission of Gift/Sale

- **DOCTRINE:**

- Rescind transaction if you make a “mistake” and state law permits
 - Scrivener’s error (i.e., mistake of fact), mistake of non-federal tax law, mistake of federal tax law
 - Mistake based upon impact of retroactive tax law change – *See Neal v. U.S., 187 F. 3d 629 (3d Cir. 1999)*(allowed donor to rescind a gift where he had relinquished contingent reversionary interest in a grantor retained income trust to avoid application of 2036(c), which was later repealed retroactively); *but see TAM 9408005* (IRS reached opposite result on similar facts) *and Lange v. U.S., 78 AFTR2d 96-6553 (N.D. In. 1996)*(disclaimer of prior gift not permitted)
- More likely to be recognized if occurs in same tax year as transaction (see *Rev Rul. 80-58, 1980-1 C.B. 181*, rescission of taxable event for income tax purposes respected if restored to original positions and in same tax year).