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Planning for Reduction of Estate Tax Exemptions: Strategies for Clients Who Do Not or Soon Will Not Have Exemptions

Gift Tax Effective Rates vs. Estate Tax Effective Rates, Net, Net Gifts, GRATs, IDGTs, and Other Strategies

TUESDAY, NOVEMBER 30, 2021

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

Today's faculty features:

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Planning for Reduction of Estate Tax Exemptions: Strategies for Clients Who Do Not or Soon Will Not Have Exemptions

STRAFFORD LIVE CLE VIDEO WEBINAR

MEGAN L. JONES

November 30, 2021

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Overview

- Planning in Light of Tax Reform
- IDGTs
- GRATs
- Qualified Small Business Stock
- Tax Proposals and Realities
- Conclusion

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PLANNING IN LIGHT OF TAX REFORM

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Key Topic Points

- Numerous proposals are currently being considered to greatly increase the impact of federal estate and gift taxes on high-net-worth US citizens and residents.
- Simultaneously many US States, including New York and California are increasing State income taxes and considering other measures, including a Wealth Tax, to further derive much needed revenue from those with substantial assets.
- The current exemption amount of $11.7 million in 2021 ($10 million, indexed for inflation, will be going down to $5 million, indexed for inflation) in 2026, if not sooner. For 2022, this exemption amount will go up to $12.06 and the annual exclusion will be $16,000.
- These developments demand an understanding of the opportunities that currently remain, and prompt action for those who wish to take advantage of them, combined with creative efforts to navigate the impact of draconian measures designed to substantially increase estate, gift and income taxes on high-net-worth individuals.

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Planning in Light of Tax Reform

- Window of Opportunity Exists under Current Law
  - Current applicable exclusion amounts are at all time highs - $11,700,000 per individual ($23,400,000 for a married couple).
  - Generation Skipping Transfer ("GST") tax exclusion is also $11,700,000 per individual ($23,400,000 for a married couple) and can continue in trust for an unlimited duration of time.
  - The applicable exclusion and GST exclusion amounts will be reduced to approximately $6,000,000 per individual at the end of 2025 ($5,000,000 indexed for inflation).
  - Even if no exclusion is available, estate planning opportunities such as sales to Intentionally Defective Grantor Trusts (IDGTs) and Grantor Retained Annuity Trusts (GRATs) can be used to transfer wealth to future generations.
  - Qualified Small Business (QSB) Stock – under current law up to $10m of capital gains can be excluded on the sale of QSB stock.

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Build Back Better: As Currently Proposed

- QSBS benefit cut to 50%
- New Section 1A would impose a surtax on high income individuals, estates and trusts. The surcharge tax would equal the sum of 5% of the amount of the taxpayer's AGI that exceeds $10 million ($5 million for married taxpayers filing separately; $200,000 for an estate or trust), plus 3% of the amount of the taxpayer's AGI that exceeds $25 million ($12.5 million for married taxpayers filing separately; $500,000 for an estate or trust).
- Vast international changes (beyond the scope of this discussion.

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Build Back Better: As Currently Proposed (cont.)

- Retirement plans:
  - The bill prohibits further contributions to a Roth or traditional IRA for a tax year if the contributions would cause the total value of an individual's IRA and defined contribution retirement accounts as of the end of the prior tax year to exceed (or further exceed) $10 million. The limitation would apply to individuals with income over $400,000 (single filers and married filing separately), $425,000 (heads of household), or $450,000 (married taxpayers filing jointly).
  - If an individual's combined traditional IRA, Roth IRA, and defined contribution retirement account balances generally exceed $10 million at the end of a tax year and the individual meets these same income thresholds, a minimum distribution would be required for the following year.
  - These provisions would be effective for tax years beginning after Dec. 31, 2028.
  - The bill prohibits all employee after-tax contributions in qualified plans and after-tax IRA contributions from being converted to a Roth IRA regardless of income level, effective for distributions, transfers, and contributions made after Dec. 31, 2021.
  - The bill also eliminates Roth conversions for both IRAs and employer-sponsored plans for single taxpayers (or taxpayers married filing separately) with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of household with taxable income over $425,000 (all indexed for inflation).

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Build Back Better: What is not included

- Earlier grantor trust changes.
- Decrease in exemption amount.
- Will any of them get added into the Senate version of the bill? Will other provisions?
- Will it pass?

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Planning Possibilities

- Gifting.
- IDGTS.
- GRATS
- QSBS.
- Complete gifts in 2021 to use exemptions, particularly long term GST exemption; take advantage of fractional discounts; use “savings clause” in deed of gift, but note Procter case; consider disclaimer.
- Gift cash or assets with high basis (in light of Van Hollen/STEP proposal).
- CRUTS.
- CLATS.
- Installment sales.
- 1031 Exchanges (note restrictions).

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IDGTS

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Intentionally Defective Grantor Trust (IDGT) and Installment Sale

- Definition
  - Intentionally "defective" trust because it is a "grantor" trust for income tax purposes yet is a "completed" gift for gift and estate tax purposes. This dichotomy is beneficial to the taxpayer and expressly sanctioned by the Secretary of the Treasury (see IRS Revenue Procedure 2004-64).
- How it works
  - IDGT is funded with an initial gift from the grantor; IDGT receives asset at low carry-over basis.
  - The Trustee of the IDGT and the grantor may choose to complete a sale from the grantor to the IDGT of an asset, often stock or an interest in a closely held business, for an installment note bearing interest at the AFR.
  - Most effective with income-producing or rapidly-appreciating assets; transfer interests into an LLC to obtain a discount for lack of control and lack of marketability, which could be as high as 30% - consult with valuation experts to determine the best structure to use.
  - The AFR is lower than the IRC Section 7520 rate that applies to GRATs (discussed below), which is beneficial to the taxpayer.

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Intentionally Defective Grantor Trust (IDGT) and Installment Sale (cont.)

- Intended Tax Results:
  - No gift tax (to the extent the initial gift is sheltered by the grantor's $11,700,000 lifetime gift tax exclusion; gifts in excess of this amount would be subject to gift tax) because the grantor receives adequate consideration for the sale.
  - All income, deductions and credits against tax of the trust will be passed through to the grantor.
  - No income or capital gains tax from the installment sale because the IDGT is a grantor trust and the IRS regards the grantor and the trust as one.
  - Interest on the note will not be included in the grantor's gross income because the grantor and the trust are treated as one.
  - Appreciation on the property sold to the IDGT will be removed from the grantor's estate for estate tax purposes with no transfer tax.

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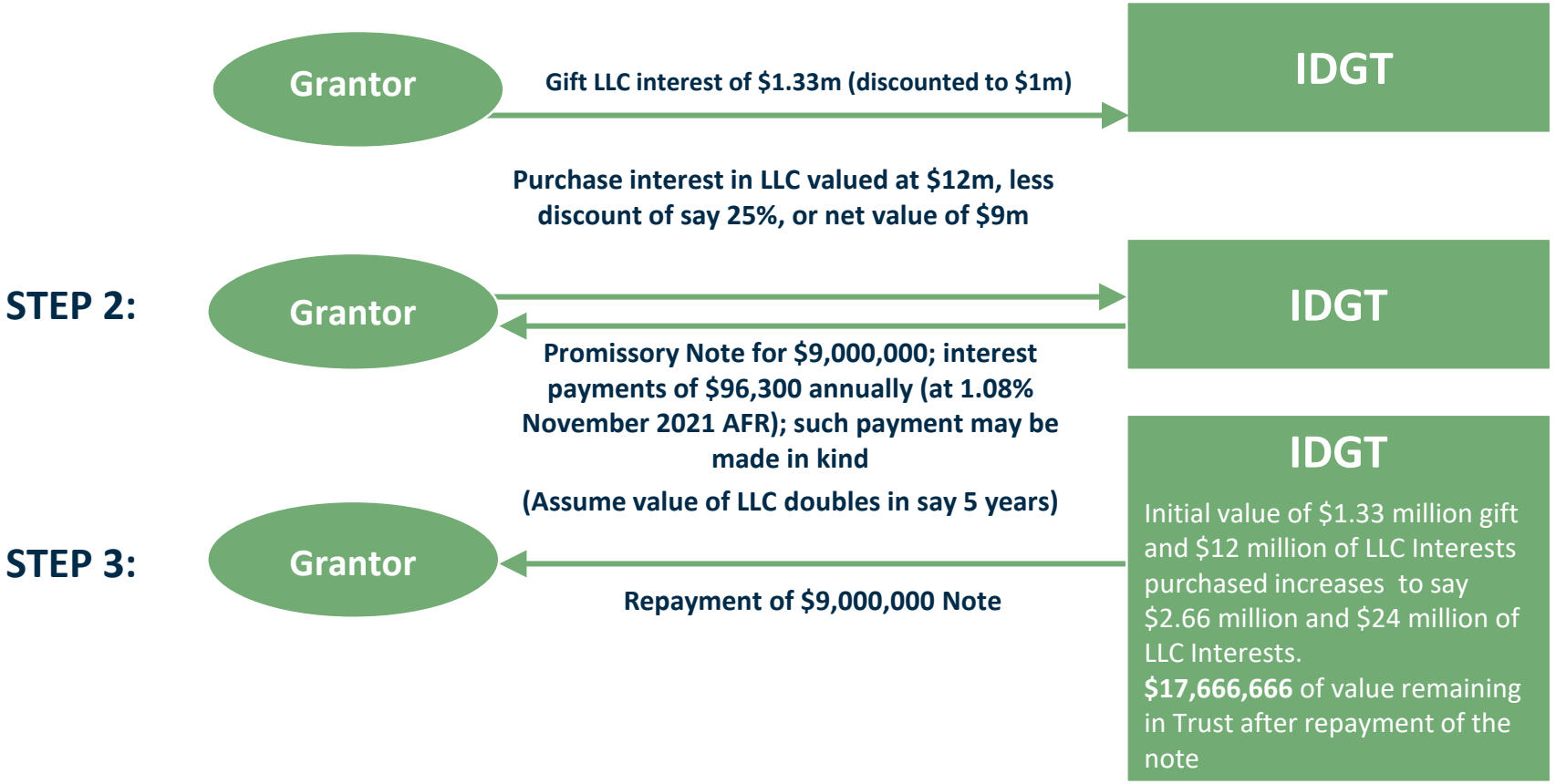
IDGT and Installment Sale (example)



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GRATS

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Grantor Retained Annuity Trust (GRAT)

- Definition:
  - An irrevocable trust to which a grantor contributes property but retains the right to an annuity stream of income from the property for a fixed term of years.
- How it works:
  - The goal is to select a term of years that the grantor is likely to survive but that also allows sufficient appreciation of assets.
  - Contribute assets that are expected to appreciate significantly.
  - Upon the expiration of the term of the GRAT, the assets and any appreciation on the assets pass to the remainder beneficiaries without any transfer tax on the appreciation.
- Intended Tax Results:
  - Transfer appreciated assets to remainder beneficiaries effectively free of tax.
    - The amount of appreciation that passes tax-free is the excess of the appreciation over the applicable interest rate.
  - The value of the remainder interest is excluded from the grantor's estate.
  - The grantor must survive the term of the GRAT to achieve potential transfer tax savings.

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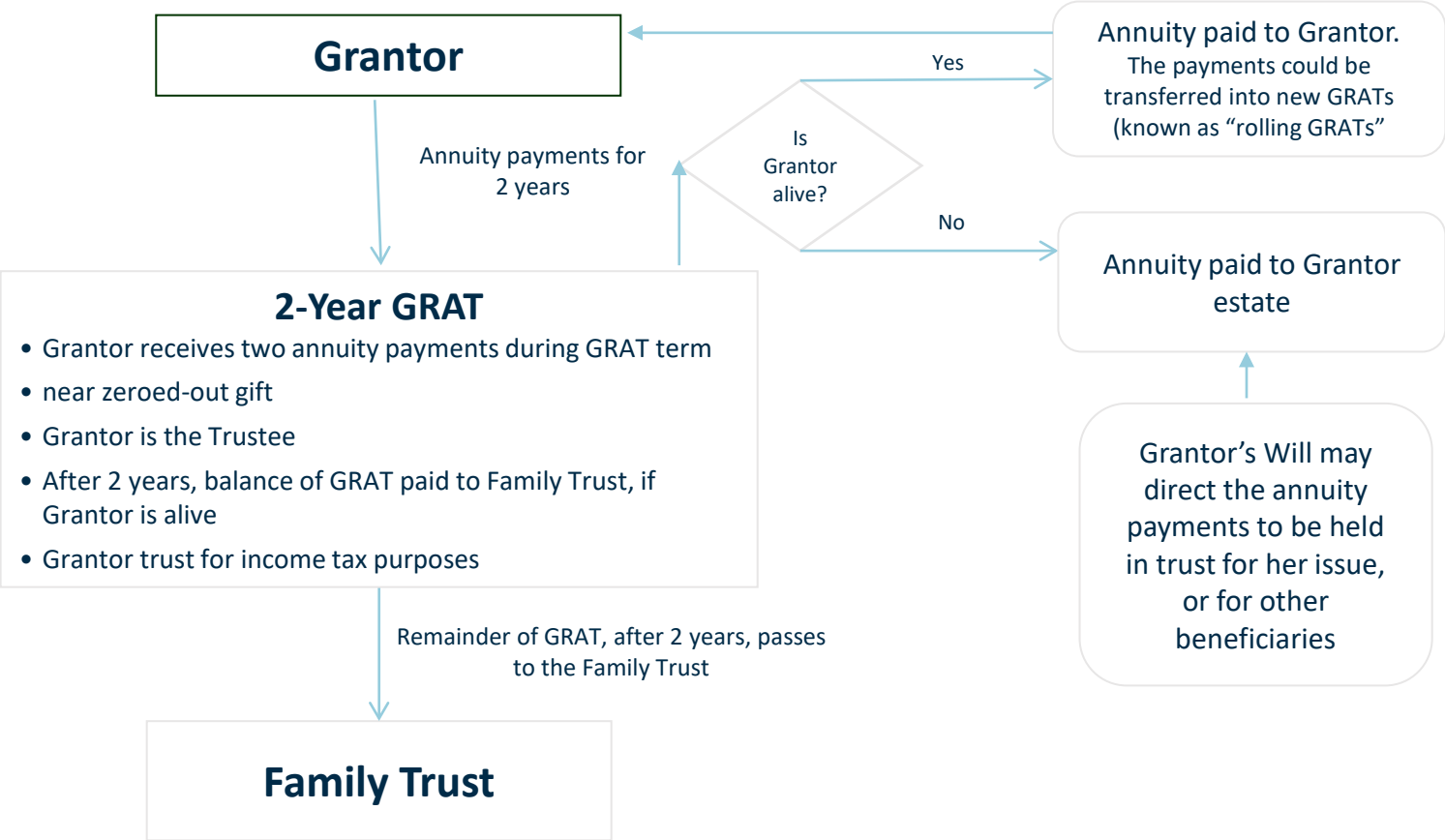
GRAT - Illustration



GRAT Advantages:

- Near zero gift exemption used when GRAT is funded.
- All appreciation on GRAT assets (less §7520 rate) is transferred to the remainder beneficiary, free of gift tax.

GRAT Disadvantages:

- If the grantor dies during the term of the GRAT, all assets held in the GRAT are includable in the grantor's estate.
- GRATs are not well-suited for GST planning.

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IDGT with Installment Sale Advantages as compared to GRATs

IDGT with Installment Sale

- Interest rates on the note are based on the AFR, rather than the §7520 rate (120% of AFR) utilized for GRATs.
- Payments on the installment note can be interest only, with all principal due at the end of the note term – this permits a larger potential transfer to the Family Trust as a larger amount of the appreciating asset can stay in the IDGT longer than in a GRAT.
- The grantor need not survive the term of the note in order to remove appreciation on the transferred assets from his or her gross estate.

GRAT

- Annuity payments go back to the Grantor and are includable in Grantor's estate.
- If GRAT assets do not appreciate at a higher rate than §7520 rate during the GRAT term, no assets will be transferred to the remainder beneficiaries (known as a "failed GRAT").
- If the grantor dies during the term of the GRAT, the assets remaining in the GRAT (including appreciation) will be included in the grantor's gross taxable estate.
- GRATs are not ideal for GST planning.

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Qualified Small Business Stock

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Planning with Qualified Small Business (QSB) Stock

- QSB stock can be sold, and up to $10m of capital gain realized on the sale is exempt from income tax. The current version of the Build Back Better Bill would limit this amount to 50%.
- Separate Non-Grantor Trusts can be established and can qualify as a separate taxpayer for QSB stock purposes.
- Example:
  - Taxpayer creates two separate non-grantor trusts, one for each child of the grantor. Each trust is funded with QSB stock
  - When the stock is eventually sold, up to $30m of capital gain can be exempt from income tax (e.g., $10m for each trust, and $10m for the grantor.
- QSB Eligibility Requirements:
  - QSB is a domestic C-Corporation.
  - QSB is engaged in one or more qualified trades or businesses (does not include most service-based businesses).
  - QSB valued at $50m or less upon stock issuance.
  - QSB stock must be acquired by shareholder upon original issuance (gifting shares to trust does not disqualify “original issuance” requirement).
  - Must hold shares for 5 years (holding period can be transferred to a trust).

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Tax Proposals and Realities

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Proposed Taxes on the Wealthy: California

- CA Wealth Tax (AB 310).
  - 1% tax on residents with a worldwide net worth in excess of $50,000,000 ($25,000,000 for a married taxpayer filing separately).
    - 1.5% tax on residents with $1 billion in worldwide net worth.
  - 4-year lookback provision for former CA residents.
    - E.g. – if a former CA resident has lived in California for 2 of the last 4 years, only 50% (2/4) of the individual's worldwide net worth would be subject to the tax.
  - Requires a constitutional amendment allowing tax on personal property over 0.4%.
    - Assembly Constitutional Amendment 8 (ACA 8) was introduced just prior to AB 310.
    - ACA 8 authorizes "the taxation of all forms of personal property or wealth, whether tangible or intangible" and eliminates the 0.4% tax rate.
  - Assets subject to the tax include but are not limited to stock in public or private corporations, pass through interests, cash and deposits, farm assets, debt securities, and indirect interests in real property.
- Millionaires Tax (AB 1253).
  - Highest marginal rate in CA is currently 13.3% on income over $1m (highest in USA).
  - AB 1253 increases income tax rates as follows:
    - 14.3% income over $1m.
    - 15.3% income over $2m.
    - 16.8% income over $5m.
- Both bills failed in 2020 but were reintroduced in 2021 with some modification, and they failed again.

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Potential Changes Coming

- Proposed legislation introduced by Sen. Bernie Sanders seeks to eliminate or substantially reduce commonly used estate planning techniques:
  - Lowers applicable exclusion amount to $3,500,000 ($7,000,000 for married couples).
  - Creates progressive estate tax rates - top rate is 65% on estates more than $1b (currently there is a flat 40% rate).
  - Limits valuation discounts on family-owned businesses.
  - Eliminates application GST exclusion to trusts lasting more than 50 years (no more dynasty trusts).
  - Eliminates use of zero'ed out GRATs.
  - Makes the grantor's payment of income taxes attributable to a grantor trust subject to gift tax.
- Another legislative proposal introduced by Sen. Chris Van Hollen would fundamentally alter the income tax environment for estate planning.
  - Eliminates "step up" in tax basis on death.
  - Triggers capital gain tax on unrealized appreciation whenever assets are transferred by gift and at death.
  - Taxes unrealized appreciation of trust assets every 21 years.
  - Applies retroactively to beginning of 2021.
  - Limits exemptions and exclusions.
    - Lifetime exemption can shield $1 million worth of unrealized appreciation from capital gain tax.
    - Additional $500,000 exclusion for personal residence and more limited exemption for tangible property.
    - Transfers to spouse and to charity would not trigger capital gain tax.

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Biden's Proposals: The American Families Plan Announced April 28, 2021 Specific Proposals in the Fact Sheet

- The top marginal income tax rate to be restored to 39.6% from the current 37% - the threshold may be what was before the 2017 tax act.
- Proposal to Restore the 39.6% marginal rate.
  - Would likely apply to income over $400,000, but
  - Application by filing status is not specified.
- 39.6% application capital gain rate for "households making over $1 million" – the "top 0.3% of all households."
  - 39.6% rate applied to capital gains over $1,000,000.
  - Pay top rate "on all income."
- Eliminating the basis "step-up" at death – gain to be recognized as taxable income at death.
- Applies for gains in excess of $1 million or in excess of $2.5 million (including principal residence) per couple when combined with existing real estate exemptions.

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Biden's Proposals in the Plan

- Close carried interest "loophole," hedge fund income to be taxed as ordinary income.
- End Section 1031 deferral of gain recognition for exchanges over $500,000 of gain "loophole."
- Permanently extend limitation on excess business losses under Section 461(l).
- Eliminate the S-Corporation dividend employment tax break; applicable to income greater than $400,000.
- Extend expanded ACA premiums tax credits.
- Extend the Child Tax Credit increases through 2025.
- Make permanent the Child Tax Credit as fully refundable.
- Make permanent the increase in the Child and Dependent Care Tax Credit (CDCTC).
- Make permanent the Earned Income Tax Credit expansion for childless workers.

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Biden's Proposals in the Plan (cont.)

- President Biden's Campaign Tax Policy Proposals – Not Addressed in April Plan.
  - Expansion of the 12.4% Social Security Tax.
  - Limiting itemized deductions to a 28% marginal rate.
  - Restoring the 3% PEASE limitation (reduction of certain itemized deductions for AGI over $313,800).
  - Phasing out Section 199 Deduction.
  - Renewable energy tax credits.
  - Home buyers first time tax credit and renters' credit to reduce "burden" of housing costs.
  - Retirement savings credit expansion.
- Eliminating the SALT cap; some Republicans agree with Sanders to avoid this benefit.
- Wealth tax (federal and state).
- Gain recognition at death and carryover basis.

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Possible Tax Planning with a Capital Gain Rate Hike

- Convert IRAs to ROTH's (if the BBB Act doesn't pass).
- Realize capital gains this year, while deferring loses.
- Delay business expenses and, if possible, state income tax payments.
- Tax free exchanges on sale of business, not asset sales.
- Installment sales.

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Possible Retroactivity

- Cautious planning needed in light of possible retroactivity.
- *See Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717 (1984); United States v. Carlton, 512 U.S. 26 (1994).

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Changing Demographic Priorities

- Increasing state income tax marginal rates.
- SALT cap reducing or eliminating deductions against federal income tax for state income or property taxes.
- Possible state wealth taxes; California and New York proposals; possible federal wealth tax.
- States offering zero income tax, no state estate tax and long-term trusts to maximize value of GST exempt trusts.
- Remote work offering flexibility in work locations.
- Impact on real estate prices in zero income tax jurisdictions; investment opportunities.
- Complexities of extricating domicile from a high tax state; offsetting considerations- being near children who reside there; proximity to high technology locations such as Silicon Valley or New York City; uprooting one's state contacts (clubs, residence, time spent in favored location); versus saving say 14% of state income tax.

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Conclusion

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Conclusion

- With passage of the Infrastructure Act we have seen the current administration making some legislative progress.
- The various versions of the Build Back Better Act have had completely different proposals regarding the provisions targeted at wealthy clients.
- We still do not have clarity regarding what – if any – provisions of the Build Back Better Act will be enacted.
- The exemption amount <u>will</u> go back to $5 million (indexed for inflation) in 2026.
- Enforcement for the wealthy will be increasing as expanding the IRS's budget seems to be a priority.
- Record keeping remains important, with increased oversight and audits likely.

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About Megan Jones

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Megan L. Jones is a tax attorney who focuses her practice on advising individuals, family offices and companies on tax, estate and succession planning, both domestically and internationally. Her work encompasses simple estate plans, more complex income and estate tax matters, along with multinational structures. She also advises individuals, investors and companies on residency issues. Megan has extensive experience in the technology industry, advising both entrepreneurs and companies on a variety of matters. Her expertise extends from the start-up phase, through a recognition event, to public company or public company executive. Previously an investment banker, working on mergers and acquisitions and public and private securities offerings, Megan brings a rounded perspective to sophisticated client issues. She has also done extensive work in the cryptocurrency space, focusing on taxation among other issues. Previously an investment banker, Megan also handles a variety of transactional matters.

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