ESTATE TAX PLANNING TODAY

The purpose of this memo is to assist in developing a better understanding of estate tax planning after the December 2017 estate tax changes. There are additional complexities for non-citizens and non-residents with US assets that will not be addressed. Additionally, non-tax estate planning issues, such as selection of guardians, trustees, and terms of inheritance, while very important, will not be addressed in this memorandum.

It should be noted that the 2017 changes "sunset" after 2025, meaning that the numbers mentioned below will be reduced by 50% absent any new legislation.

BASIC TAX RULES OF ESTATE PLANNING

- You can pass an unlimited amount of assets to your US citizen-surviving spouse at death without tax.

- Each person has an $11,200,000 total exclusion for assets passing to non-spousal heirs, during their lifetime and after death. Therefore, a married couple, for example, can pass as much as $22.4 million to their family during their lives and after death. This exclusion is indexed for inflation.

- Each person can give each non-spousal beneficiary $14,000 per year without gift tax consequences. If married, with spousal consent, you can give $28,000 per beneficiary. The direct payment of tuition or medical expenses of another person does not count towards this limit.

  Once you exceed the $14,000/$28,000 limit, you consume part of your $11.2 million gift/estate/generation-skipping exclusion. For example, if a single person gave her child $40,000 one year, that person's remaining $11.2 million exclusion would be reduced by $26,000. If that person never made a taxable gift, the remaining gift/estate exclusion would be $11,174,000.

- The gift/estate tax rate once you have exceeded the $11.2 million exclusion is 40% for federal purposes.

- State death taxes are deductible against your federal taxable estate. This effectively produces a 40% tax savings if an estate is subject to federal estate taxes.

- Gifts or bequests to grandchildren are not only subject to gift and estate tax, but also the Generation Skipping Tax (GST). The lifetime/after death GST exclusion is $11.2 million as well, but the tax on transfers in excess of the exclusion is an additional 40%.

- **The estate exemption is now portable after your passing to your surviving spouse.** This means that if a spouse dies, any unused part of his/her $11.2 million exclusion can be assumed by the surviving spouse, to be used at her death. For example, if someone passed away leaving everything to his surviving spouse, that estate would not be using any part of the $11.2 million exemption. If an estate tax return is filed and the survivor elects to "port" the exclusion, the surviving spouse can pass as much as $22.4 million tax-free to the children at her death. **An estate tax return must be filed after the first death to take advantage of portability.**

  The advantages and disadvantages of portability will be discussed later in this memo. However, portability only applies for estate tax purposes – it does not apply for GST purposes. It is probably not appropriate for those whose estate planning includes bequests at death to grandchildren or trusts that could be for their eventual benefit.

- The income tax basis of assets is marked up or down to the fair market value at death.

- Insurance death benefits are generally part of your estate at death, unless someone else owns your life insurance.

SOME THOUGHTS REGARDING BASIC ESTATE PLANNING STRATEGY UNDER THE NEW LAW

If you do not have estate documents and you are married with an estate of less than $22.4 million, you may want to consider outright wills passing everything to your surviving spouse.

For estates well in excess of $22.4 million, you should continue to reduce your estate tax exposure in ways that continue to meet your personal goals and objectives with respect to your family and charities.

If you are single with an estate of less than $11.2 million, you similarly may not need a complex estate tax plan.

<u>SOME THOUGHTS REGARDING PORTABILITY OF THE ESTATE EXEMPTION</u>

For the past 40 years, traditional estate planning for wealthy married couples involved using the estate exemption upon the death of the first spouse. For example, if the estate exclusion were $1 million, upon the first death $1 million might pass to a trust for the benefit of the surviving spouse and children, and the remainder would pass to the surviving spouse either outright or in trust. The estate exclusion trust generally would not be included in the surviving spouse's estate for tax purposes.

Under previous rules, if you did not use the estate exclusion at the first death (and instead passed everything to the spouse outright), the benefit of the exclusion would be permanently lost, and family estate taxes would not be minimized.

Portability gives your family another option, because the exclusion is not lost when it is not used at the first death of the spouses. Instead, the first spouse's exclusion can be claimed by the surviving spouse if not used at the first death (assuming an estate tax return was filed). Adding portability was supported by both political parties, as it would simplify estate planning at the first death by negating the need for a trust.

There will likely be further clarification of the rules, especially as it relates to remarriage. Currently, the surviving spouse can only "port' the unused exemption of his/her last deceased spouse. The new portability feature has even led to amusing speculation that wealthy people might marry terminally-ill, poorer people to be able to claim their estate exemption.

Some of the advantages of portability are:

- It simplifies the affairs of the surviving spouse by negating the need for a trust at the first death.
- It preserves flexibility for the surviving spouse.

Some disadvantages of portability are:

- The GST exemption does not "port". If at some point, you desire to leave money to grandchildren, portability could increase the family tax burden.
- If you fund a trust at the first death, you also remove future appreciation on trust assets from the surviving spouse's estate. This reduces the eventual death taxes.
- Setting up a trust at the first death does provide some assurance as to where the funds will pass after the surviving spouse's death. In other words, it does provide some remarriage protection.
- If no trust is set up at the first death, you might lose the benefit of your state's death tax exemption. If your state has a death tax, the exemption is likely much less than $11.2 million, but likely will be lost if not used at the first death.

BASIC ESTATE TAX PLANNING

For estates likely to be worth well in excess of the estate exclusions, there are some relatively simple techniques that can be used to reduce the eventual tax burden:

- Gift early and often. Make use of the $14,000/$28,000 annual per beneficiary exclusion, assuming you do not need the funds for your own retirement planning. Pay tuition and medical expenses directly for children and grandchildren.

- Consider funding part or all of the $11.2 million/$22.4 million gift tax exemption during your lifetime either outright or in trust. If a married couple gifted $10 million to children / grandchildren and we assume an after tax return of 5% per year, in 14 years the gift would have doubled in value. The future tax on the $10 million of appreciation at 40% is $4 million.

- Consider the state where you live and will ultimately die. Some states have death tax rates of as high as 16%; many, such as Florida, have no death taxes.

- For very large estates, make gifts in excess of the $11.2 million/$22.4 million gift tax limit. Such gifts will generate 40% gift tax, and the "benefit" is that you remove the gift tax from your estate. You have to survive the gift by 3 years to reap this benefit, however.

  If a married couple, for example, had never used their exemptions, and then gifts their children $32.4 million, the first $22.4 million will be tax free, and the next $10 million will generate a tax of $4 million. This $4 million will not be taxed in the parent's estates at their deaths, resulting in a savings of $1,600,000. There may be additional state tax savings, as well, if your state does not have a gift tax.

ADVANCED ESTATE TAX PLANNING

Many advanced estate techniques have two characteristics in common: they remove future appreciation on assets from your estate, and they allow you to discount the market value for tax purposes. Here are some of the most common:

A. Qualified Personal Residence Trust (QPRT)

- In a QPRT you transfer property – a personal residence, including a vacation home – to a trust for a designated term of years, during which time you are entitled to the use of the property. At the end of the trust term all the property in the trust is distributed to the designated "remainderman" – usually children or a continuing trust for their benefit. If you die during the trust term the trust property reverts back to your estate leaving you in the same position as if you never created the QPRT.

- The taxable gift is the present value of the remainderman's expectation of receiving the trust property at the end of the trust term. This present value is computed without assuming any appreciation on the property. For example, if a 60-year old put a $2 million house in a QPRT for 15 years, at 3%, the gift tax value of the gift of $2 million is approximately $946,000. If the house appreciates in value by 3% per year, it will be worth $3,116,000 in 15 years, saving the family $868,000 in potential death taxes at 40%.

- The QPRT is an especially effective estate planning technique where significant growth is expected in the value of the residence, and in particular where the trust generates little or no ordinary income. This is because the actuarial valuation of the gift anticipates that you will receive income (the right to use the property) and the principal value will stay flat.

- There is no prohibition against using mortgaged property in a QPRT (although the IRS may take the position that the original gift is based only on the net equity in the house, with each future mortgage payment constituting in part a further gift to the QPRT). You will also continue to pay taxes, insurance and routine maintenance expenses, and will continue to benefit from all applicable income tax deductions. You will also be subject to capital gains tax on a sale of the residence, but will retain the right to exclude capital gains upon a sale of the home.

- In the case of a residence held jointly by husband and wife, the ownership should be partitioned so that each can create a QPRT with his or her undivided interest in the home. Their QPRTs can be for the same term or for different terms. Because each spouse is making a gift of a minority interest in the home, there is authority for valuing each 50% interest at significantly less than one-half of the total appraised value of the home. A recent court case allowed a 20% discount.

- The question of what will happen to the home at the end of the QPRT term can be handled in several ways. In the simplest situation your children will then own the home, and you can arrange at that time to rent the home for fair market rental from the children. Alternatively, the home can continue in a further trust for the children's benefit for the life of you and your spouse after the QPRT term, and you can enter into a rental arrangement with the trustee.

- The QPRT is an excellent opportunity to partially utilize one's lifetime exemption painlessly and effectively. It is painless because it does not involve the use of cash or liquid assets. It will be effective because the actuarial discounting will result in an eventual transfer of the home to children at a gift tax value only a fraction of the actual value of the home.

B. Grantor Retained Annuity Trust ("GRATs")

- A GRAT, which is similar to a QPRT, requires that a designated fixed annuity be paid each year to the grantor (you) whether or not the trust has any income, and at the end of the term the property passes to the designated remaindermen.

- If the grantor dies during the term of the GRAT, there will be at least partial inclusion of the trust assets in her gross estate for estate tax purposes. In general, if there has been net appreciation in the trust principal, a portion of that appreciation may be excluded from estate tax.

- Regardless of the GRAT term and the annuity payout, if the actual performance yield of the trust is greater than the IRS discount rate – the remainderman will receive a benefit greater than the taxable gift component of the GRAT. However, if the taxable gift component of the GRAT is substantial, the GRAT may not be a particularly effective way of utilizing one's lifetime exemption, especially because of the possibility that the assets may decline in value. On the other hand, if the GRAT is structured so that the taxable gift component is small or negligible – for example, an 18% annuity for 7 years, a 29% annuity for 4 years, or a 54% annuity for 2 years – the transaction will not use up any significant portion for the lifetime exemption. This is commonly known as a "zeroed out GRAT" (future legislation may eliminate zero grats).

- With a "zeroed out GRAT" it is not necessary to actually earn the annuity amount in order to achieve a tax benefit – so long as the investment performance exceeds the IRS discount rate there will be some residual value in the trust at the end of the term, which is passed gift tax free to the remainder beneficiaries. And if the investment performance does not meet the IRS discount rate, all of the assets will be returned to the grantor in satisfaction (or partial satisfaction) of his retained annuity, but with no adverse gift tax results because there was little or no taxable gift at the outset. In other words, placing assets in a zero GRAT has upside potential but little downside risk from an estate-planning standpoint, except for the cost and time in administering the trust.

C. "Defective" Grantor Trust

- The Internal Revenue Code contains a series of provisions, known as the grantor trust rules, which are designed to prevent taxpayers from artificially splitting their taxable income among family members – particularly children – through the use of trusts. Under these rules, if a trust contains any of various prohibited "strings", the trust's income will be taxed to the grantor (you) even though you do not actually receive it or benefit from it.

- In short, a parent can place assets in an irrevocable trust for children, which contains a string which causes it to "flunk" the grantor trust rules (but does not cause inclusion in the grantor's taxable estate). Although all the trust's income is either accumulated for the children (or grandchildren) or paid out to them currently, the Internal Revenue Code mandates that the grantor report all the income (including capital gains) on his own Form 1040 and pay the resulting income tax. This payment by the grantor of the income tax on the children's income is effectively a gift to the children, totally outside the gift and estate tax structure.

- This "defective" grantor trust can be used as a vehicle for making annual exclusion gifts or for utilizing all or a portion of one's lifetime exemption. It may be particularly useful for making gifts of stock in family businesses because, unlike many trusts, it will automatically be a permitted shareholder in a Subchapter S corporation.

- Another desirable attribute of a defective grantor trust is that sales and other transactions between the grantor and the trust are not taxable events for income tax purposes. This permits the grantor to purchase appreciated assets from the trust without causing a capital gain.

- The ability to purchase assets from the trust without causing capital gains can be particularly useful where a defective grantor trust has substantial appreciated assets and the grantor is elderly or for other reasons has short life expectancy. In this case if the grantor purchases the appreciated assets at their current market value for cash or a promissory note, upon his subsequent death the assets will receive a "stepped-up" basis and the potential capital gain will be eliminated. Special rules apply for QPRTs which prevent a grantor from repurchasing the residence.

D. Life Insurance Trusts

- An irrevocable life insurance trust should be used when it is desirable to remove life insurance proceeds from the taxable estate or to control management of the insurance proceeds. A life insurance trust should be strongly considered where the estate exceeds

$11.2 million ($22,400,000 when combined with the spouse's estate), so that the insurance proceeds would be subject to tax in the insured's (or the spouse's) estate if held outside the trust.

- Where an existing insurance policy is transferred to a trust, the trust will be effective to exclude the policy proceeds from the insured's estate only if the insured transfers all rights and incidents of ownership in the policy – such as the right to change the beneficiary and the right to draw down cash surrender value – and only if you survive the transfer by three years.

- If the trustee is the applicant, owner, and beneficiary of a newly issued policy, the three-year rule will not apply. Therefore, the policy proceeds can be excluded from the insured's estate even if the insured does not survive for three years from the purchase of the policy.

- The insurance proceeds continue to be available to provide liquidity. The executors of the estate can sell illiquid assets to the trust, at fair market value, to provide cash to the estate for the payment of taxes and expenses.

- The surviving spouse can be given an interest in the trust – either an outright income interest of an interest in income and principal in the discretion of the trustee.

E. Family Limited Partnerships ("FLPs")

- Creating an FLP, combined with other techniques, such as a "defective" grantor trust (discussed above), can yield substantial estate planning benefits. A parent can contribute assets to the FLP, the partnership units of which are then transferred to the heirs directly or to a trust for their benefit.

- When given to the heirs directly (and sometimes when given to a trust), the gift can qualify for the $14,000 annual exclusion, without the need to give fractional interests of the underlying property, which can sometimes be illiquid. Also, when given to a trust, if the trust is structured as a "defective" grantor trust, the income from the trust is taxed to the grantor, regardless of who receives it. This allows the grantor to make further tax-free gifts of the funds used to pay the income tax.

- One of the main benefits of the FLP is that in valuing the gift of the partnership units given to heirs, a substantial discount may be available, since the property that is now given is a minority interest in assets that are tied up in a partnership. The lack of marketability of the FLP units, and the cost of unwinding the partnership are also taken into account in valuing the property given away, thereby allowing an even greater discount. You will need a professional valuation to have any chance of defending a discount upon audit.

- An additional benefit of the FLP is that the parent, as general partner, has effective control over the partnership investments and distributions. There is a potential problem, however, if the general partner retains voting rights over shares of a company contributed to a FLP.

F. Transfer of Executive Stock Options to Trust

- Stock options are beneficial because they allow executives to participate in corporate appreciation without investing capital. To minimize the potential estate tax on this appreciation, executives should consider transferring stock options to trusts for the benefit of their children.

- Transfer of stock options to trusts for the benefit of children removes an appreciating asset from an executive's estate at a relatively low gift-tax cost (or at no current cost through the use of annual exclusions or the unified credit). When the option is exercised, the executive is taxed on the appreciation as compensation. At that time, the trust's stock basis is "stepped up" to the exercise date value and immediately can be sold without incurring any tax liability.

- The executive's estate is diminished by the taxes he or she pays, and the heirs enjoy the benefit of that tax in the form of a stock basis adjustment. This can be viewed as an additional gift from the executive that is generally exempt from tax.

- There may be several possible drawbacks to the transfer of stock options to trust.

  - Existing stock options are generally nontransferable. Employer stock option plans would need to be modified to allow for limited transferability to certain types of trusts.
  - In our opinion, the gift cannot be made until the option tranche has vested in the right to exercise.
  - The stock's value may not appreciate, making the options worthless. In the meantime, you have used some of your gift/estate tax exclusions. The gift tax value of options is based on Black Scholes or similar formulae, so this technique only works where stock values rise substantially after grant. Some economists believe Black Scholes overstates option values, which would then overstate the gift tax value.

CONCLUSION

The estate planning techniques outlined in this memorandum can be used to accomplish a variety of estate planning goals. Using them in the right combination to suit your individual needs can be pursued with our assistance.