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Estate Planning Opportunities Remain in 2021

by Michael D. Whitty

A FREEBORN & PETERS LLP CLIENT ALERT

Estate Planning in the first quarter of 2021 provides continuing opportunities for clients seeking to preserve and transfer wealth while minimizing or avoiding gift taxes. This Client Alert provides information on **three hot topics:**

1. **Using Gift Tax Exemptions in 2021 While Avoiding Risk of Retroactive Cuts:** Election Outcome Leaves Retroactive Cut in Gift Tax Exemption a Possibility, but Some Techniques Allow Use of the Larger Exemptions in 2021 While Protecting Against Retroactive Cuts

2. **Interest Rates Still Low, But Trending Upward:** Estate and Gift Tax Savings From Intra-family Loans, Installment Sales, Loan Refinancing, and Grantor Retained Annuity Trusts (GRATs), At Least Until Congress Curtails Those Techniques

3. **Popular and Powerful Wealth Transfer Techniques May Be Curtailed by Congress:** The New Administration Has Proposed, And The New Congress Will Be Predisposed, to Cut Several Powerful Estate Tax Savings Techniques and Rules: GRATs, Valuation Discounts, Basis Step-up on Death

Our prior 2020 Client Alerts (found here, here, here, and here) addressed other topics that remain current:

- Health Care Documents and Estate Plans in the face of **Coronavirus**
- Planning for Retirement Accounts After the **SECURE Act** of 2019
- The new **Illinois Uniform Trust Code** and Its Effects on Trust Design
- Planning for Possible Changes in **Estate and Gift Tax Exemptions**
- Gift and Intra-family Loan Refinancing Opportunities with **Low Interest Rates**

If any of these topics raises concerns or questions for you, contact one of the Freeborn & Peters attorneys listed below (Email would be best under current conditions, as most of us are working remotely for much of the time as of January 2021).

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All of our clients who are serious about reducing estate tax exposure should arrange a call to discuss how to best take advantage of the opportunities presented by current conditions of low valuations and lowest-ever interest rates, as well as the currently high estate and gift tax exemptions that will be reduced by the end of 2025 if not sooner.

Introduction: Effect of Election Outcome on Possible Estate Planning Changes

The 2020 US Election came to a delayed conclusion on January 5, 2021 with the Democrats winning both Georgia Senate runoff elections to achieve a 50-50 Senate, in which Vice President Elect Harris will break ties. That situation is similar to that in the first half of 2001, when then Vice President Cheney was the tiebreaker.

The Democratic "Blue Wave" achieved its goals, but just barely. Their tenuous majorities in the House and Senate will give them little room to maneuver if dissidents threaten to withhold votes. However, legislation that unifies the Democratic House and Senate caucuses will be able to pass (and will be signed into law by President Elect Biden), except where the filibuster still applies in the Senate. Tax bills fall in the reconciliation and budget categories, however, and thus are not subject to a filibuster.

As noted in previous Bulletins, the Biden campaign and its allies have proposed substantially cutting the estate and gift tax exemption from its current $11,700,000 per person. One option is to accelerate the "sunset" provision—already in current law, but not to take effect until the end of 2025—which would halve the current exemption. The other proposed option is to roll the exemptions back to 2009 when the estate tax exemption was $3,500,000 per person while the gift tax exemption was only $1,000,000. The Biden-Harris campaign also proposed raising the gift and estate tax rate from 40% to 45%.

There is the possibility, supported by legal and historical precedent, that a tax bill passed in 2021 could be **retroactive** to **January 1, 2021**. As one example, the 1993 tax bill raised the estate tax rate retroactively, with the Supreme Court upholding the change in response to a taxpayer challenge on constitutional grounds. If the 2021 Congress makes such a retroactive change, the tax result for an estate planning transfer in 2021 could be much worse than the current rules in place at the time of the transfer.

A number of factors present today would make such a retroactive change to estate and gift tax exemptions less likely: the thin margins for the Democratic majorities, the "poor optics" of making tax hikes retroactive, and the number of other legislative priorities where the Democrats would want to spend their political capital. Nevertheless, taxpayers with enough wealth to be concerned about estate and gift taxes and who did not use all of their gift tax exemption by the end of 2020 are facing a dilemma: either try to use their full gift tax exemption in 2021 with the risk that a retroactive cut in the exemption would lead to payment of a substantial gift tax, or not make such gifts and risk losing the exemption forever.

In addition to proposed reductions in the gift and estate tax exemptions, the Biden campaign had proposed substantial curtailment of several powerful estate planning techniques, including Grantor Retained Annuity Trusts, transfers of family-owned entities with valuation discounts reflecting real-world factors (such as lack of marketability and lack of control), installment sales to grantor trusts, and the step-up in tax basis for appreciated assets held at death. As with the gift tax exemption, retroactive changes to the tax treatment of such transactions are unlikely, but possible.

This bulletin will describe several ways we could **reduce or eliminate** those risks of retroactive tax changes for taxpayers who make significant estate planning transfers in 2021.

1. Using Gift Tax Exemptions in 2021 While Reducing Risk of Retroactive Cuts

Tax-Exclusive Gift Tax Calculation Means That Gift Taxes Are Better Than Estate Taxes. First, taxpayers with sufficient wealth to consider making transfers to reduce future gift and estate taxes should keep in mind that because of the tax-exclusive nature of the gift tax, paying gift tax (and then surviving the gift by three years) is better than paying estate tax on the same assets or value. The term "tax-exclusive" is meant to describe a tax where the funds used to pay the tax are not included in the taxable amount. Sales taxes are one example, and gift taxes are another. As gift taxes are generally borne by the donor and paid out of the donor's funds other than those used for the gift, the effective rate for gift taxes is lower than if the funds used to pay the gift tax were themselves part of the tax base.

In contrast, a tax-inclusive tax is one where the taxable amount actually or effectively includes the funds used to pay the tax. Income taxes are one example, where the taxes are paid out of the taxable income itself (or from other funds on

a fungible equivalent basis). Estate taxes are also tax-inclusive, as the taxable estate includes the funds to be used to pay the tax (or non-cash assets that would be sold or borrowed against to raise the cash to pay the tax). An exception to the preceding description is gift taxes on a gift made within three years of death, as those taxes must be added to cumulative taxable gifts and thus become part of the estate taxable amount.

The lesson here is that payment of gift tax is not the worst possible result; payment of estate taxes on the same amount will always be worse. Nevertheless, if transfers can be made in a way to reduce or avoid gift tax, most taxpayers would prefer to do so.

Second, there are some techniques to mitigate the gift tax that could be very helpful in the current situation where we have large exemptions under current law but are concerned about a retroactive reduction in those exemptions. Three of those techniques described in this Bulletin are (i) the **disclaimer,** (ii) the **net gift agreement**, and (ii) the **lifetime QTIP marital trust**.

Disclaimers. The trustee of a trust receiving a gift could be empowered (in the gift assignment, if not already empowered in the trust agreement) to **disclaim** all or a portion of the donated assets. A disclaimer is an election to not accept all or a portion of a gift. A valid ***disclaimer*** is treated as if the donee had never received the property. For a disclaimer to be recognized as valid under federal law, the disclaimer must occur within nine months of the gift and before the donee has used the gifted property. Use of the property means spending the cash or income from the gift, or making use of an asset (but not merely taking possession or investing the cash or asset).

In a situation involving a 2021 gift, the trustee could disclaim property as to which the trustee had taken possession but not used the property, at any time up to nine months after the gift. That period is likely long enough to achieve some certainty about whether there will be a retroactive reduction in the estate and gift tax exemption. Based on the history of tax law changes, such a retroactive reduction is much more likely to occur (if at all) in the second or third quarters of 2021 rather than in the first or last quarter. In the event it happens, the trustee could disclaim enough of the gift property to reduce or eliminate the additional gift tax triggered by the retroactive reduction of the gift tax exemption.

Net Gift Agreements. The trustee of a trust receiving a gift could enter into a **net gift agreement** with the donor at the time of the gift. A net gift agreement reverses the general rule that the donor pays the gift tax, and obligates the donee to pay any resulting gift tax (usually but not always out of the property contributed as part of that gift). If Congress passes no retroactive reduction in the gift tax exemption in 2021, there would only be gift tax to the extent the donor made a gift in excess of the exemption available on the date of the gift. The net gift agreement could provide that the donor would pay that planned and anticipated gift tax as the donor normally would. If Congress *does* pass a retroactive reduction in the gift tax exemption, the trust would agree to pay that resulting unanticipated gift tax out of the trust property. This actually reduces the taxable gift, because the funds used to pay the gift tax reduce the amount of the gift. Consequently, that trust would pay less tax on that gift amount than the donor would.

Lifetime QTIP Marital Trust. A QTIP Marital Trust is a popular device for taxpayers who would like to defer estate taxes to the death of the surviving spouse. The QTIP Marital Trust accomplishes this by sheltering that amount in excess of the decedent's available estate tax exemption in a trust that qualifies for the estate tax marital deduction. The qualified terminable interest property (or "QTIP") election makes that trust eligible for the **marital deduction** even though the donor spouse gets to choose where the property passes upon the surviving spouse's death. The marital deduction avoids tax on the QTIP trust property in the predeceasing spouse's estate, while the QTIP tax rules make the trust includible in the surviving spouse's estate.

A QTIP Marital Trust can also be set up **during lifetime** as a completed irrevocable gift. This Marital Trust can use and absorb some of the available gift tax exemption *unless* the QTIP election is made on the gift tax return to apply the marital deduction and avoid a current taxable gift. That election can be deferred until the time to file the 2021 gift tax return in April 2022. This approach provides the greatest time to a taxpayer to apply a **wait-and-see approach**.

- If the election is made, the marital deduction applies, and there is no taxable gift (but the trust will be includible in the spouse-beneficiary's estate). This will rescue the gift from a retroactive cut in the gift tax exemption.
- If the election is not made, the marital deduction does not apply, and the gift uses gift tax exemption. After the first year, if the election was not made, an independent party can exercise a special power of appointment over

the Marital Trust to transfer some or all of the Lifetime QTIP Marital Trust to another trust for the family that can accumulate some or all trust income, and can allow other current beneficiaries in addition to the beneficiary spouse. This may be preferable to leaving the funds in a QTIP Marital Trust, which limits distribution to the spouse and requires mandatory distribution of all trust income.

Combinations of these techniques can also work, such as a disclaimer by the trustee of a tax-sensitive trust (such as an irrevocable trust for family) so that it would pass to a tax-deferred or tax-free trust (such as a Lifetime QTIP Marital Trust or a GRAT).

2. Interest Rates Still Low, But Trending Upward

The IRS released the January 2021 Applicable Federal Rates on December 16, 2020, which reflected a trend toward slightly increased rates since the September 2020 rates that were the lowest since those rates began to be issued. These rates are "safe harbor" rates used to assure there is no imputed additional interest for income or gift tax purposes. Trends in the markets since December 2020 suggest that Applicable Federal Rates will increase substantially in February 2021.

As discussed in greater detail in our June 2020 Client Alert bulletin, these rates offer savings not only for clients seeking to reduce estate tax exposure, but also for clients seeking to reduce their family members' interest expenses through refinancing. While the rates have been on a slightly upward trend since August, they remain low when considered in historical context, and future rates may be much higher once the Federal Reserve determines it needs to combat inflation.

The techniques that use the Applicable Federal Rates to provide estate and gift tax savings include intra-family loans and loan refinancing, installment sales to grantor trusts, and Grantor Retained Annuity Trusts (GRATs). All these techniques remain valuable for transfers that shift future growth and appreciation without gift taxes, at least until Congress curtails those techniques (see the next item).

January 2021: The Section 7520 rate is 0.6%				
The AFRs are as follows	**Annual Compounding**	**Semi-annual Compounding**	**Quarterly Compounding**	**Monthly Compounding**
Short-term (up to 3 years)	0.14%	0.14%	0.14%	0.14%
Mid-term (3 to 9 years)	0.52%	0.52%	0.52%	0.52%
Long-term (over 9 years)	1.35%	1.35%	1.35%	1.35%

The low Section 7520 Rate provides opportunities for certain techniques, validated by the tax laws, that use this rate to compute the present value of a retained or charitable interest. These techniques include the grantor retained annuity trust ("GRAT") and the charitable lead annuity trust ("CLAT"), described in detail in our June 2020 Client Alert bulletin.

3. Popular and Powerful Wealth Transfer Techniques May Be Curtailed by Congress

The new administration has proposed, and the new Congress will be predisposed, to cut several powerful estate tax savings techniques and rules: GRATs, valuation discounts, and basis step-up on death.

GRATs (grantor retained annuity trusts) allow donors to shift future growth and appreciation in transferred assets with little or zero use of their gift tax exemptions or payment of gift tax, as explained in detail in our June 2020 Client Alert bulletin. Proposals by the former Obama administration and the Biden campaign would throttle the GRAT in two ways: by requiring a minimum ten percent taxable gift (so that the annuity retained by the grantor to reduce the taxable gift by the grantor to reduce the taxable gift could no longer offset 100% of the transfer, only 90%) and by imposing a minimum ten year term (so that shorter term GRATs, perhaps implemented in series, can better take advantage of volatility to shift more appreciation). If a GRAT makes sense for a taxpayer, that taxpayer would be better off implementing one now under the current rules and

low interest rates.

Valuation discounts can apply to family-owned entities, whether operating businesses or investment joint ventures. The discounts reflect factors that depress valuation in the real world, including lack of marketability and lack of control. The Obama administration and Biden campaign have proposed reducing or eliminating the availability of these valuation discounts for family-owned entities (although it is possible that legislation might allow them to continue for operating companies and only eliminate the discounts for investment vehicles). Taxpayers who have existing entities now eligible for valuation discounts, or who might wish to create one, should consider making transfers with such interests while the current rules are still in place.

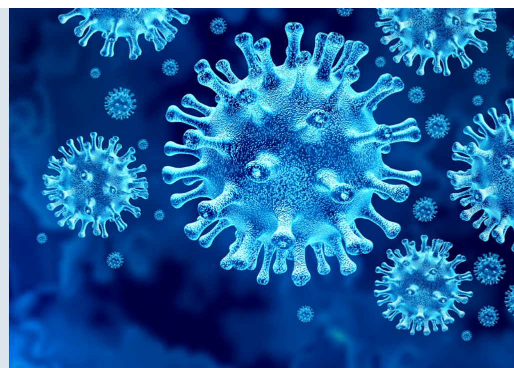
Basis Step-Up at Death has been part of the income tax system for decades, with short gaps in 1976-1980 and in 2010. Under the current rule, a decedent's assets have their basis adjusted to their fair market values as of the decedent's death, whether or not that decedent paid estate tax or even had to file a return. The alternative approach, carryover basis, means that the decedent's heirs and beneficiaries receive the same tax basis in assets as the decedent had, with the burden of proof on the heirs and beneficiaries. This can require meticulous recordkeeping by individuals to avoid leaving their heirs and beneficiaries with a default basis amount of zero. The Biden campaign not only proposed eliminating basis step-up at death, but also proposed imposing capital gains at death, making a bequest or inheritance into a capital gains event as if the property were sold for its then fair market value. Taxpayers who have been holding on to highly appreciated assets in hopes of avoiding capital gain with basis step-up may want to reconsider, especially if they can sell before capital gains rates go up.

REMINDER – INCENTIVE FOR CHARITABLE GIVING:
One item from the 2020 CARES Act that is still effective for 2021 is the $300 deduction
(only for cash gifts to public charities, excluding donor advised funds)
available for taxpayers who take the standard deduction and do not itemize deductions on their income tax returns.

Freeborn's Response to COVID-19

Freeborn & Peters COVID-19 Task Force, with dozens of COVID-19 related Client Alerts and links:
https://www.freeborn.com/practice/covid-19

Bill Russell's White Paper on client result using a GRAT:
https://www.freeborn.com/perspectives/real-life-example-transferring-growth-without-gift-tax



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Michael Whitty is a Partner in the Corporate Practice Group. He concentrates his practice in estate planning, taxation, and estate and trust administration. Michael represents business owners, principals of venture capital and private equity funds, key executives, investors, and other high net worth individuals in planning for the preservation and transfer of their wealth.

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