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# UPDATES TO ESTATE PLANNING AND TO CHANGES TO ESTATE AND GIFT TAX LAWS

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Below are updates to the recent changes in tax and other laws affecting clients' estate planning.

The increased federal gift and estate tax exemption amount means that only a small number of persons who die will actually have their estates pay an estate tax. Clients need to be concerned with what might happen to the federal estate and gift tax exclusion, exemption and tax rates, after the 2020 presidential election and in 2026 when the current high estate tax exemption amount is set by statute to be reduced.

## 1. *Gift and Estate Tax Exemption Increases in 2020*

The unified federal gift and estate tax basic exclusion amount (known as the **"Gift and Estate Tax Exemption"**) increases to $11,580,000 per person on January 1, 2020 (or a total of $23,160,000 combined for a married couple)[1]. This exemption amount under current tax laws will increase further in future years for inflation adjustments. Under the current high estate tax exemption, the Joint Committee of Taxation stated that only about 1,800 of all of the persons who died in 2018 actually had their estates pay a federal estate tax.

After December 31, 2025, the Gift and Estate Tax Exemption is scheduled to revert back to a $5,000,000 amount, increased for inflation. This scheduled drop in the Gift and Estate Tax Exemption amount on December 31, 2025 had raised concerns that pre-2026 gifts that utilized the increased Gift and Estate Tax Exemption could trigger an estate tax "clawback" (for gifts that use the increased exemption amount the gifted amount might be recaptured and taxed at death for persons dying after 2025). However, the Treasury Department issued proposed Regulations on November 20, 2018 indicating that there would be no "clawback" of gifts made before 2026. Thus, there should be no "clawback" of federal estate taxes on gifts made before 2026 up to the applicable Gift and Estate Tax Exemption at a donor's later death.

Clients with large estates should consider now making lifetime gifts to use this large exemption prior to its sunsetting on December 31, 2025. Additionally, if the Democrats gain control of both the White House and Congress in 2020, there could be an effort to reduce this Gift and Estate Tax Exemption amount even prior to 2025.

Note that if your client is a nonresident alien individual, the Gift and Estate Tax Exemption amount increase does not apply, and the exclusion amount for the nonresident alien's estate remains at only $60,000.

***a. Maximizing the Use of the High Gift and Estate Tax Exemption Amount***. The increased Gift and Estate Tax Exemption amount can be maximized at the first spouse's death by either using a Bypass Trust (sometimes known as a **"Decedent's Trust"**). Alternatively, the second-to-die spouse (upon the death of the first-to-die spouse) can rely upon the "portability" tax provision, which allows the second-to-die spouse to utilize the first-to-die spouse's estate tax exemption amount (along with the second-to-die spouse's exemption amount). To utilize "portability" an estate tax return must be filed for the first-to-die spouse even if no estate tax is due. If the second-to-die spouse remarries then this "portability" provision ceases to apply to the first-to-die spouse's exemption.

***b. Maximize the Use of the Increased Exemption Amount by Making Lifetime Gifts***. Clients can lock in the use of the increased Gift and Estate Tax Exemption amount by making lifetime gifts of assets to their children and grandchildren. Thus, even if the Gift and Estate Tax Exemption amount is reduced by Congress in the future, clients who have made prior gifts can take advantage of the current high Gift and Estate Tax Exemption amount. Family partnerships, grantor retained annuity trusts and sales to grantor trusts can be utilized by clients to take advantage now of this high exemption.

## 2. Generation-Skipping Tax Exemption Increases in 2020

A generation-skipping transfer tax is imposed in addition to the federal estate and gift tax. Clients desiring to leave assets to their grandchildren or even great-grandchildren must take into consideration the generation-skipping tax and the generation-skipping tax exemption amount. The generation-skipping transfer tax remains at a forty percent (40%) rate and applies to gifts or bequests made at death or during lifetime, greater than the generation-skipping tax exemption amount, to a person who is two or more generations below the transferor. Thus, the generation-skipping tax applies to gifts to grandchildren or to other persons who are more than thirty-seven and one-half (37.5) years younger than the transferor.

In 2020 the generation-skipping tax exemption amount will increase to $11,580,000 (or to $23,160,000 combined for a married couple). Thus, a married couple can structure their estate plan to gift or leave at death up to a combined $23,160,000 of assets to their grandchildren free of generation-skipping taxes. This generation-skipping tax exemption amount is not portable. Therefore, each spouse needs to plan in their trust document the use of their own generation-skipping tax exemption amount.

## 3. Formula Clauses in Clients' Will and Trust Documents Which are Tied to the Estate and Gift Tax and the Generation-Skipping Tax Exemptions Need to be Reviewed

Many trusts and estate plan documents contain formula clauses which state that amounts being left to specified children, grandchildren and other family members are equal to the "estate tax exemption amount" or to the "generation-skipping tax exemption amount". These formula

clauses can unwittingly result in clients leaving more assets to certain persons than that client otherwise intends (such as that client leaving too large an amount to certain children and/or grandchildren). For example, clients in the past may have stated in their trust or Will that the "generation-skipping tax exemption amount" (which in 2020 is $11,580,000/person or $23,160,000 for a combined married couple) goes to their grandchildren, which means that the client may in their trusts and Wills leave more assets to that client's grandchildren than that client otherwise intends. Thus, it is important that a client review their trust and Will documents' formula clauses in order to verify that those clauses properly reflect that client's current intentions.

### *4. Clients can Continue to Make Annual Gifts Using the Gift Tax Exclusion Amount Which in 2020 Remains at $15,000 per Donee*

The annual gift tax exclusion amount per donee for 2020 remains at $15,000 per donee (or $30,000 per donee in total by a married couple). This gift tax exclusion amount can be used by two gifting spouses to make gifts to their multiple children and grandchildren each year. Additionally, unlimited amounts can be paid by a parent or grandparent gift tax-free for their child's or grandchild's qualified medical and tuition payments (these amounts must be paid by the donor directly to the medical provider or to the educational institution in order to qualify). This $15,000 annual exclusion amount under current tax laws automatically increases in future years based upon inflation adjustments.

### *5. California's Taxation of Trust's Income*

The U.S. Supreme Court in the trust income tax case of the ***North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*** decided in 2019 that states do not have the power to tax a trust's income, where the only contact with that state was that the trust beneficiaries who received no actual trust distributions, were residents of that state. The trust in this case was formed in New York, a New York resident was the trustee, and New York was the location of the trust's administration. However, North Carolina had aggressively tried to tax the trust's income even where the North Carolina trust beneficiary received no income distributions.

This ***Kimberley Rice Kaestner*** case for the most part should not affect California trusts since California only imposes an income tax on a trust's undistributed income if that trust's beneficiary is a noncontingent beneficiary. In other words, for California trust beneficiaries (where the trustees are not California residents) if the trust beneficiary cannot compel trust distributions of income, then that trust should not be subject to California income taxes on its undistributed income.

### *6. California Proposals to Enact a California Estate or Inheritance Tax*

Proposals in the California legislature and attempts to pass by a ballot measure a California estate and inheritance tax have not succeeded to date. However, since about one-third (1/3) of the

states currently have some form of state estate or inheritance tax, and the fact that various California interest groups are looking for more tax revenues to fund their causes, it can be anticipated that efforts will continue in the future to have California enact some form of an estate or inheritance tax.

## 7. *Wealthy Clients Can Now Fund Dynasty Trusts Tax-Free, Which Benefit Grandchildren, Great Grandchildren and Succeeding Generations*

Clients with large amounts of wealth and exposure to federal estate taxes could establish dynasty trusts to take advantage of the current high Gift and Estate Tax Exemption amount. Dynasty trusts, which can be combined with family limited partnerships (utilizing valuation discounts for minority interests and lack of marketability) allows the transfer of significant amounts of the family's wealth to lower future generations at little or no gift, estate or generation-skipping tax cost. The dynasty trust can be allowed to continue for multiple generations of the family. Clients can combine the increased $11,580,000 generation-skipping tax exemption (or $23,160,000 combined for a married couple) with the Gift and Estate Tax Exemption, and valuation discounts in order to transfer their wealth tax-free to their children, grandchildren, great-grandchildren and even lower future generation levels. This planning technique allows the tax-free transfer of a significant amount of the family's wealth to future generations.

## 8. *Clients Need to Plan for Their Assets' Income Tax Basis at Death*

The income tax basis of assets in a decedent's estate are adjusted to those assets' fair market value at the decedent's death (and for community property assets upon the death of either spouse).

With the increased exemption amount clients need to plan for income tax basis increases at their death (or that of their spouse for community property assets). For example, clients could retain in their estate certain assets to allow for the step-up in the income tax basis, and those assets remain protected by the high Gift and Estate Tax Exemption from being subject to estate taxes.

The new California trust "decanting" statute at Probate Code §19501, allows clients to redesign their existing irrevocable trusts (by creating a new trust) to allow those trust assets' income tax basis to be stepped-up upon the death of a trust beneficiary. Basically, the California decanting statute allows the transfer of assets from an existing trust to another new trust provided that certain conditions are met (such as that the new trust benefits substantially the same beneficiaries, and that specified notice requirements are complied with). Accordingly, some of the income tax basis planning ideas outlined below can be implemented by using this new California decanting statute.

***a.*** ***Using a General Power of Appointment to Achieve Income Tax Basis Increases***. To obtain a future step-up in income tax basis for trust assets consider including in the trust

document a general power of appointment, with a formula that such general power of appointment will only be triggered to the extent that it would not cause an estate tax or generation-skipping tax.

***b.*** ***Allow Trust Assets to be Swapped***. Another planning technique with trusts is to use provisions allowing assets to be "swapped", exchanged or sold out of the trust to another person so that those swapped out assets can then obtain a higher income tax basis when those assets' recipient owner dies.

***c.*** ***Deciding on the Use of a Bypass Trust***. Clients need to determine with the current large Gift and Estate Tax Exemption amount whether they wish to utilize a Bypass Trust or to instead include all of both spouses' assets in the taxable estate of the second-to-die spouse for federal estate tax purposes. This is especially important in light of the fact that California residents owning community property receive a step-up in income tax basis for both halves of the community property at the death of the first spouse and can then achieve a second step-up in income tax basis at the death of the second spouse as to those assets included in the second spouse's taxable estate.

Now with portability of the Gift and Estate Tax Exemption amount (portability is the ability of the first-to-die spouse to transfer their exemption amount to the second-to-die spouse) and the fact that the exemption amount is now in 2020 $11,580,000 per person, couples need to evaluate whether they want to use portability instead of using a Bypass Trust.

***d.*** ***Using Disclaimers***. Another planning alternative to achieve a step-up in income tax basis on the death of the second-to-die spouse is to include in the clients' estate plan a disclaimer power whereby the second-to-die spouse has the choice to direct, on the death of the first spouse, assets to a Bypass Trust. At the first spouse's death the second-to-die spouse could elect not to exercise such disclaimer and instead have such assets included in the taxable estate of the second-to-die spouse upon that second-to-die spouse's death (rather than having the first-to-die spouse's assets go to a Bypass Trust).

***e.*** ***Using a Special Trustee in Order to be Able to Change the Trust's Provisions in the Future***. Another planning idea to obtain a stepped-up income tax basis upon the death of a trust's beneficiary is to have the trust document specify that there will be a separate special trustee (**"Special Trustee"**) who has the power to grant a trust's beneficiary a general power of appointment if that Special Trustee deems it advantageous from an income tax standpoint (so, for example, the Special Trustee may decide to give that trust's beneficiary a general power of appointment so that the trust's assets would receive a step-up in income tax basis when that trust's beneficiary dies).

***f.*** ***Evaluate the Types of Assets Being Gifted to Children for Which a Step-up in Income Tax Basis will be Lost at the Parent's Death***. The client needs to consider whether gifting assets to children during that client's lifetime risks losing the potential step-up in those assets' income tax basis that the client's heirs would otherwise receive had that client instead retained

those assets until the client's death. For example, clients with community owned property may wish to retain assets until the death of the first-to-die spouse before gifting those assets.

If the client makes lifetime gifts of assets to their children, then the client should consider gifting only assets that are not likely to be immediately sold by those children (such as having the client make gifts to their children of stock of a closely held business in which the children are working).

## ***9. Effect of the Current Low Interest Rates on Estate Planning***

In the past, clients have used estate planning techniques to take advantage of the low federal interest rates (which recently has been two percent (2%) or less). In November 2019 the federal AFR long-term interest rate will be 1.94%. Accordingly, as an example, clients can make direct ten (10) year loans to their children, and any amounts earned by the children in excess of 1.94% will be retained by the children gift tax free.

***a. Use of Grantor Retained Annuity Trusts ("GRATs")***. Grantor Retained Annuity Trusts (sometimes known as **"GRATs"**) utilize the §7520 rate to value the remainder portion (that is, that portion which is left to the clients' children when the trust terminates) for federal gift tax purposes. The parents retain the annuity portion of the GRAT (where the parents receive an annuity for a specified number of years). When the GRAT term expires the children are then able to receive the GRAT's remaining assets gift and estate tax-free. The §7520 rate (the rate used for GRAT calculations and to determine the present value of a term of years and remainder interest) is currently low (at 2% in November 2019), making the use of GRATs advantageous.

***b. Use of Grantor Trusts (known as "Defective Income Trusts")***. Similarly, grantor trusts (sometimes referred to as **"Defective Income Trusts"**) in the past have taken advantage of the low federal AFR interest rates in order for a parent to sell their assets to these grantor trusts (which benefit the children and grandchildren). In the sale the parents receive back a promissory note at no income tax cost (since the trust is a grantor trust). These promissory notes pay interest to the parent/seller at the AFR interest rate. With current low AFR interest rates Defective Income Trusts remain an effective tax planning tool for clients.

## ***10. Use of Family Limited Partnerships to Reduce Gift and Estate Taxes***

Family limited partnerships (and limited liability companies) have been approved in prior cases by the courts to enable clients to transfer large amounts of the family's wealth tax-free to lower generational family members utilizing minority and lack of marketability valuation discounts. Clients have used valuation discounts (such as for a minority interest or for lack of marketability) to transfer gift and estate tax-free to their children and grandchildren, the clients' real estate, businesses, stocks and bonds portfolios, and partnership and limited liability company interests.

It should be noted that the IRS has attacked family limited partnerships (with some success) in the recent tax case of ***Estate of Powell***[2]. However, the taxpayer prevailed in the 2019 valuation case of ***Estate of Jones***[3] in using an income approach to value gifts of limited partnership interests. An income valuation approach in ***Estate of Jones*** allowed the taxpayer to value the partnership like an operating company (thereby producing a lower valuation) rather than based upon the value of the partnership's assets. The Tax Court in ***Estate of Jones*** recognized discounts applicable to limited partnership interests due to lack of control and marketability. Importantly, the Tax Court in ***Estate of Jones*** allowed taking into account a tax rate for potential federal and state taxes on business operations (which in turn then reduced the entity's value for tax purposes).

These recent tax cases show that partnerships need to be properly planned and operated to achieve tax savings.

## ***11. Clients Need to be Careful to Avoid Triggering "No Contest Clauses" in Will and Trust Documents***

Many Will and trust documents contain clauses stating that if a beneficiary challenges that particular Will or trust document, or makes a claim against the estate then that beneficiary is disinherited. These provisions are known as **"No Contest Clauses"**. However, No Contest Clauses in certain cases can trigger unintended results by entirely disinheriting a child or other beneficiary. For example, a beneficiary may have a legitimate reason to challenge a trust document for reasons such as mistakes in that document or that the document may have been signed under undue influence.

California amended its No Contest Clause statute in 2008 at Probate Code §21311, in an effort to minimize unintended effects of No Contest Clauses. However, in the recent California Court of Appeals decision of ***Key v. Tyler***, 34 Cal. App. 5$^{th}$ 505 (2019) the Court stated that a trust's child beneficiary's "defense" of an invalid trust amendment, if that defense is made without probable cause, could potentially trigger a No Contest Clause and disinherit that child. The Court found that the trust amendment in ***Key v. Tyler*** had been prepared under undue influence. Thus, not only was the child unable to enforce this trust amendment, but that child's attempted enforcement of that trust amendment potentially disinherited the child under the trust's No Contest Clause.

The ***Key v. Tyler*** case highlights that clients need to be cautious to not trigger a No Contest Clause should that client challenge a Will and/or trust provision, make claims against an estate, or try to enforce certain provisions contained in a Will or trust.

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1 By statute the federal gift and estate tax exemption is adjusted annually by changes in the Chained Consumer Price Index for all Urban Consumers published by the U.S. Dept. of Labor Statistics, for the twelve-month period ending the previous August 31st. Thus, this latest adjustment for 2020 is based upon the index released for August 31, 2019. The Chained Consumer Price Index increases to the gift and estate tax exemption was enacted as part of the 2017 tax law changes and is <u>less generous</u> than was the former formula for increasing this exemption each year.

2 In ***Estate of Powell***, 148 TC 392 (2017) the Tax Court applied §2036(a)(2) to a limited partnership interest to bring that limited partnership interest back into the decedent's estate for federal estate tax purposes.

3 ***Estate of Jones***, TC Memo 2019-101 dealt with valuing limited partnership interests in a partnership owning a timber business, which had active business operations managing timberlands and harvesting the timber.

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