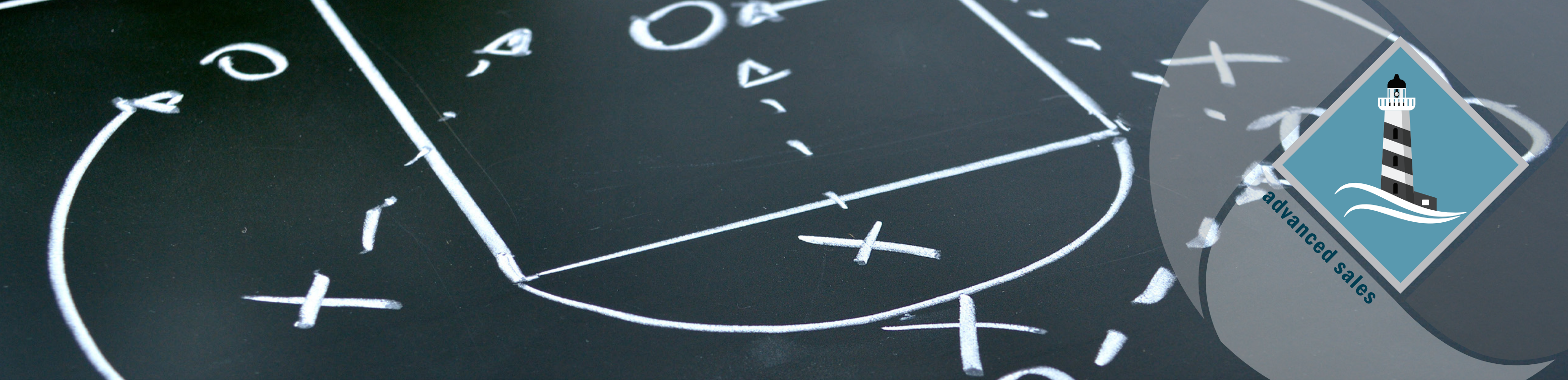

Preparing Clients for a Quick Estate Planning Pivot Now That There Is a New Administration and Congress

High-net-worth clients recognize that they need to be prepared for sudden changes in tax laws and market valuations. Increased taxes on gifts and estates seem to be imminent since the Democrats gained control of the White House and both houses of Congress, but no one knows exactly what will change or when. When change comes, there may be little to no time to adjust plans to the change, and even retroactive impacts to the beginning of the tax year are possible. Attorneys and appraisers may be backlogged with similarly situated clients. Here are some tips for setting up trusts for estate planning with flexibility to pivot quickly as possibilities turn to actualities.

Use "intentionally defective" irrevocable grantor trusts.

"Intentionally defective" grantor trusts that are **not** considered a separate *income* tax entity (i.e., the income of the trust is taxable to the grantor) enhance the flexibility of irrevocable trusts, because, under current rules, transactions between the grantor trust and the grantor are not income-taxable events. In other words, gains are not recognized when a grantor trust purchases an appreciated asset[1] (including a life insurance policy worth more than its basis) from the grantor for fair market value or vice versa. However, this non-recognition treatment is based on Revenue Ruling 85-13, which could be revoked without formal rulemaking, so this option could disappear with little notice. Regardless of whether that happens, the Tax Code provides that, if the grantor lends funds to their grantor trust (private finance), the interest paid by the trust back to the grantor is not taxable.

Include "swap powers" (grantor right of substitution) in the trust terms.

When a trust gives any person (including the grantor), in a non-fiduciary capacity, the ability to substitute assets of equal value (without requiring the consent of any adverse party), it will automatically be classified as a grantor trust while the grantor is alive.[2] The "swap" power gives grantors the ability to change their minds about which assets should be inside or outside the trust, and make adjustments without needing the approval of a trustee. (However, the trustee should still have the power to determine the value of the assets being swapped to ensure they are actually equivalent.) This can be particularly beneficial for real estate and other low basis assets that are owned by a trust: if they are swapped for high basis assets while the grantor is still alive, the low basis assets may get a substantial step-up in basis if included in the taxable estate, while assets in the irrevocable trust do not.

Use loans to trust (private finance) in lieu of gifts in certain situations.

LOAN

Already maxed out for the gift tax exclusion? Not ready to commit to giving up control of an asset? Concerned about the possibility of large gifts becoming taxable retroactively?[3] In each of these situations, selling an asset to trust in exchange for a promissory note can be a good solution. The minimum interest rates charged for private loans are extremely low in today's economic environment, and as mentioned above, the interest paid back to a grantor is not taxable income. A loan can be quickly converted into a gift by forgiving the promissory note. Conversely, the grantor can regain control over some or all of the assets by calling the note and the trust transferring assets back to pay off the note.

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Choose a jurisdiction with favorable trust modification (i.e. "decanting") rules.

Concerned about needing to change terms of the trust in the future, such as modifying beneficiaries or responding to unanticipated tax law changes? Trusts operate according to state laws, which vary substantially in their options for modifying or replacing an irrevocable trust. The applicable state law is generally determined by the state in which the trust is "administered" (generally, this is where the trustee is located). So, clients can set up a trust in a different state from their usual residence with the selection of a professional trustee located in a more favorable jurisdiction.

Use "Wandry" defined value clauses for transfers of hard-to-value assets.

Need to quickly make a gift of exactly $11 million dollars out of a closely-held business interest worth $50-80 million? What share of the business should be gifted? You may not have time to get an appraisal done before making the gift, and in any case, the IRS is not bound by the findings of an appraiser. The 2012 Tax Court decision, *Wandry v. Commissioner*, opened the way to making a transfer of a determinate dollar value, with the number of shares determined *later* according to a formula specified in the gift or transfer document as finally determined by the IRS.[4] In June 2020, the Tax Court assessed the taxpayer in *Nelson v. Commissioner* with costly deficiencies and penalties for a defined value clause that relied solely upon the determination of an independent appraiser, even though the appraiser was well-qualified and their values were not unreasonably lower than the final values determined by the court.

Why Not Just Wait?

Tax laws can change with little notice, even retroactively. For instance, in August 1993, the Omnibus Budget Reconciliation Act (OBRA) was made law, which included an increase in the top estate tax rate from 50% to 55%, retroactive to January 1, 1993. A number of courts affirmed the constitutionality of this retroactive tax hike. A shift in policy or control of the federal government any time in 2021 may result in tax changes effective back to January 1, eliminating the possibility of "reacting quickly."

But what if Congress isn't able to come to agreement about tax hikes after all? There are still several good reasons to act now rather than later:

- Future growth of an asset transferred out of the taxable estate today will not be subject to transfer tax (at least to the extent that the generation skipping transfer tax (GSTT) does not apply).
- Interest rates are at historical lows, making private financing and grantor-retained annuity trusts exceptionally attractive.
- Assets in trust, if transferred properly, enjoy greater asset protection against potential future creditors who might unexpectedly make claims on a grantor's wealth.
- State governments have their own income and transfer tax rules, and their own political currents. States may hike transfer taxes even if the federal government doesn't.
- Transferring interests in businesses and real estate at a time when their values are depressed by economic conditions allows wealthy clients to move a higher percentage of their assets outside the taxable estate without incurring gift taxes than if they wait for values to recover.
- Today's tax rules and circumstances are only today's. Politicians may resign or die suddenly. Markets move quickly. Regulators issue new guidance without notice that can sometimes upend planning assumptions. There is no guarantee that rules will survive for long.

Think your clients may need to pivot? Contact your Crump representative to help draw up a game plan.

[1] Assumes no debt against the asset.
[2] Tax Code Section 675(4)
[3] The technical way the gift tax exclusion works under Sec. 2505 of the Tax Code is by determining whether an amount would be estate taxable if the donor had died on the last day of the calendar year in which the gift is made. Therefore, if Congress were to lower the estate tax exclusion effective mid-year and not make special provision for the calculation of gift taxes based on a different date, gifts made earlier in the same year the exclusion is changed could become retroactively taxable.
[4] Be careful to follow well-tested formula language that allows a final determination of value by the IRS.