



THE SCOOP ON UNFAVORABLE FEDERAL TAX LEGISLATION FOR ESTATES & TRUSTS

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Senator Bernie Sanders released his proposed tax reform legislation on March 25th which outlined major changes to the estate and gift tax rules. This bill, which was co-sponsored by Senators Kirsten Gillibrand, Sheldon Whitehouse, Jack Reed and Chris Van Hollen, will have a similar version read into the House of Representatives by Representative Jimmy Gomez.

This bill is impactful and complex from a financial aspect, but is straightforward in how it would achieve its goals – by reducing the current estate and gift tax exemption levels to \$3,500,000 and \$1,000,000 respectively beginning in 2022 and significantly eliminating or curtailing many of the important planning techniques used by estate planners effective upon enactment. The following commentary seeks to summarize and sort out some of the more important aspects of the pending legislation and, perhaps more importantly, outline what exactly we stand to lose.

The following helps to explain the rules, and provides some helpful pointers along the way:

UNFORTUNATELY FOR MANY, THE EXEMPTION WOULD BE ONLY \$3.5 MILLION (minus any past reportable gifts) - USE IT OR LOSE IT!

Effective the first day of 2022, the estate tax exemption amount would drop to \$3.5 million per person from the present level of \$11.7 million per person. This means the exemption for a married couple would only be **\$7,000,000, a 70% decrease!** In addition, the rate will not be adjusted annually to account for inflation.

Many individuals (for good reason) will seek to gift a majority of what remains of their existing \$11.7 million exemption prior to year end, but it is important to note that if an individual's lifetime reportable gifting does not exceed \$3.5 million, then the current additional exclusion amount will be wasted. In other words you have to "use" the current \$11.7 million exemption or "lose it".

EXAMPLE 1:

Bob has made \$2 million of taxable gifts and has \$9.7 million of his exemption remaining. If Bob uses another \$1.5 million of his exemption, then he will have nothing left for 2022 if the legislation were to pass since total prior gifts would be equal to \$3.5 million.

Bob may be encouraged to use at least \$6.2 million of his exemption before year's end so that he does not lose that amount, and should consider using the full \$9.7 million of exemption remaining. Bob would have to give more than \$3.5 million in total in order to take advantage of the current increased exclusion amount.

The amount (in the example) may be transferred to an irrevocable trust for the benefit of Bob's spouse and descendants. That trust may also benefit Bob in the event Bob were to suffer any financial hardship, so long as the trust is properly formed and operated in a creditor-protection jurisdiction.

It is likely that many married couples, in response to this rule, will have one of the spouses establish the above-referenced trust for each other and the couple's descendants, while the other spouse establishes a trust that solely benefits the couple's descendants.



This type of planning is in response to what is known as the “Reciprocal Trust Doctrine.”

The end of this year will be a contemplative time for wealthy individuals who are, (or who have family who are) in intensive care, as there will be significant estate tax savings that could come with “pulling the plug.”

Surviving spouses who already have their portability allowance will not have this allowance reduced under this legislation.

EXAMPLE 2:

Bob’s wife Sally dies in 2021 and leaves all of her assets to Bob. Bob will then have an \$11.7 million portability allowance, in addition to his own \$3.5 million estate tax exemption if the law passes. Bob could therefore pass \$15.2 million estate and gift tax-free, so long as he does not re-marry and the new spouse dies before him. In such situation, the new spouse’s portability allowance would be substituted for the amount of Sally’ allowance “ported” to Bob.

New Year, New Limits: The gift tax exemption would be limited to \$1,000,000 beginning January 1, 2022.

As previously mentioned, the current estate and gift tax exemptions are set at \$11.7 million, minus whatever taxable gifts have been made previously. Such exemption is reduced whenever gifts are made that exceed \$15,000 per person in any given year.

In Example 1, Bob has a \$9.7 million exemption remaining after a prior gift of \$2 million. If the legislation passes, Bob’s tax exemption will go down to \$1 million in 2022, and after reducing this amount my prior gifts made, Bob will have no exemption remaining to make future gifts without paying gift tax.

In other words, Bob will only be able to gift the \$15,000 of assets per year/per person without paying gift tax. Many families, in response to this change, will make significant gifts in 2021 in order to use the increased exclusion amount in case this legislation passes.



It is worth noting that many clients of the author and of other well-respected estate planning attorneys will choose to leave some of their exemption amount intact, to protect against the possibility of the IRS conducting a gift tax audit and finding that certain gifts were under-reported.

EXAMPLE 3:

Frank owns 49% of ABC, Co., which is worth \$30 million. The 49% ownership of the company is valued for Frank at significantly less than \$15 million because of valuation discounts. These discounts account for the ownership share’s lack of marketability and lack of control. The courts do not align as to determining what percentage of valuation discount applies, but most claim that the determination involves the individual facts and circumstances. In many situations (such as this one), a compromise is struck and the valuation discount is placed somewhere between where Frank thinks it should be and where the IRS auditor thinks it should be.

A typical plan would involve Frank gifting the 49% ownership to a trust for the benefit of Frank’s wife and descendants. The transfer may be valued at \$10,000,000 (assuming a 33.33% discount rate), which would leave \$1,000,000 of exemption remaining as a buffer in case the IRS were to challenge the valuation of the company or the applicable discount taken so that no gift tax would be owed on any adjustment.

If the new law passes Frank would have no exemption remaining for future transfers, except for increases caused by inflation adjustments on the \$1 million base exemption amount if an inflation adjustment is included in a final bill, as the exemption would drop to \$1 million for gift tax and \$3.5 million for estate tax, which is less than the amount Frank will have already gifted during his lifetime.

Future transfers would need to be below \$15,000/ per person or gift tax would be due and payable.

Many Are IRRATE at the Rate Increases.

The current flat estate tax rate of 40% will also go up in 2022 if the proposed bill is passed.



This increase will make the rate a progressive rate beginning at:

- 45% for taxable estates between \$3.5 million and \$10 million,
- 50% for estates between \$10 million and \$50 million,
- 55% for estates between \$50 million and \$1 billion,
- and 65% for estates over \$1 billion.

EXAMPLE 4:

Leonard dies with \$2 billion in his estate in 2022. Leonard, before his death, never made a taxable gift. Leonard's rates are as follows:

- 45% – After accounting for the \$3.5 million exemption, the next \$6.5 million (for a total of \$10 million in assets).
- 50% – The next \$40 million (a total of \$50 million in assets).
- 55% – The next \$950 million in assets (from \$50 million to \$1 billion).
- 65% – Anything that is above \$1 billion in assets.

One of the biggest victors of this change would be charities. It is likely that many will benefit under this legislation as individuals seek to donate large amounts of money during their lifetime in order to maximize deductions and reduce estate tax exposure.

Many families establish their own private foundations that can qualify for these deductions and allow for family members to control the foundations and even receive compensation for services rendered, as long as the charitable foundation rules are followed.

This should increase if this Act is passed. IRA's can also pass to such foundations to avoid both income tax on withdrawal and estate taxes, where the combined tax rate on death can exceed 75%, or more. While charities should be excited, they should be sure to remember that any changes that this legislation might bring would not go into effect until the beginning of 2022.

Taxpayers have approximately nine more months to plan accordingly for these changes.

Moving fast is important as many of the key strategies in planning for this legislation (such as irrevocable trusts and certain discounts) will be rendered unavailable should this Act pass.



Do not get discouraged, however, as many great estate planning techniques will still be available after this legislation's potential passing.

These include:

- Low-interest rate promissory note installment sale planning between family members;
- Self-cancelling installment notes; and
- Charitable Lead Annuity Trusts (CLATs).

While the above planning tools are excellent, the three tools that will either be disappearing completely or curtailed heavily under this act are even more helpful to most individuals. These (soon-to-be-gone) tools are:

- Grantor Retained Annuity Trusts (GRATs);
- Grantor Trusts; and
- Family entity discounts.

Should this act pass, the following outlines some of the other changes that are set to occur:

ELIMINATING DISCOUNTS FOR NON-BUSINESS ENTITIES AND ASSETS

Married couples can presently place \$15 million of assets into an LLC and then each spouse can then sell a 49% ownership in that LLC to an irrevocable trust in exchange for a \$5 million note each (which assumes a 33.33% valuation discount)

This type of valuation would not be possible under this new Act. The new Act would amend the IRC and require that family entities base their valuation on the pro-rata percentage of ownership times the value of all the underlying assets. The exceptions to this valuation rule under the new legislation are very slim.

The legislation includes new look-through rules which seek to prevent against entities abusing the valuation discount rules.

Under this new legislation, even a 10% ownership of an entity being held by an entity will be valued at 10% of the value of the assets owned by such entity. Presumably ownership of less than 10% can be discounted, but this takes away significant discounts that used to apply to minority ownership interests.

THEY WORKED OUT THE “DEFECTS” IN GRANTOR TRUSTS

In what is a crushing blow to estate planning and tax professionals across the U.S., Section 2901, which would be added to the IRC under this legislation, would mandate that any trust which is created, funded, or transacted with after the date of enactment of the law, and is considered to be owned by the Grantor for income tax purposes or by a person that exchanges assets with such trust, will be subject to federal estate tax on the death of the Grantor as if the Grantor him or herself owned the trust’s assets.



Good-bye “Defective Grantor Trusts,” given that the passage of this law will make it essential that grantor trusts be fully funded and established before the enactment of such legislation.

TO RECAP:

Currently, a taxpayer can create a trust that will (a) not be subject to federal estate tax but (b) will be considered as owned by that taxpayer for income tax purposes. Doing so enables the taxpayer to pay the income tax on trust earnings without the payment of such taxes being considered a gift. Alternatively a taxpayer can sell significant assets to the trust in exchange for long-term low interest rate promissory notes, special notes that may vanish on death, or special arrangements called “Private Annuity Sales” that may be used without triggering income tax on the exchange. The taxpayer may also exchange assets with the trust on an income tax-free basis.

MODIFICATIONS

One piece of good news from the legislation is that capital gains taxes may still be avoided when the estate of a recently-deceased person is sold, as IRC 1014 still provides that any assets owned at death will receive a step up (or step down) in basis equal to their fair market value “date of death” amount.

EXAMPLE 5:

Olivia owns stock worth \$100,000 on death that cost her \$10,000 initially. If Olivia’s family sells the stock for \$110,000 after Olivia’s death, then only \$10,000 is taxed as capital gains.

The question remains, however, what would happen if Olivia were to gift stock before she died to an irrevocable trust that was (a) located outside of her estate for estate tax purposes, but (b) considered to be owned by her for income tax purposes?

Under this new legislation, when the owner of a Defective Grantor trust dies, no fair market value (FMV) income tax basis will be assigned for the assets of the trust unless the trust is included in the Grantor’s estate. This is a definite defeat for those with existing grantor trusts who wished to continue those trusts’ existence until death.

There is still uncertainty in the law as to whether a new FMV income tax basis will be received when the Grantor of a trust disregarded for income tax purposes dies. Estate planning experts are split as to whether the step-up should be received. This pending law change is evidence that those who pre-decease the law’s enactment should get the step up in tax basis.

This provision would apply for all irrevocable trusts, including those formed prior to the passage of this Act, that are treated as owned by the Grantor of the trust.

TRUE GRIT ABOUT GRATs

This legislation would severely impact the efficacy of an important planning structure known as the Grantor Retained Annuity Trust (GRAT).



Using a GRAT, a taxpayer can place assets in a trust and have all growth (exceeding a fairly low rate-of-return) pass to family members without such passage being considered a “gift” for tax purposes.

The Walton family, behind the Wal-Mart brand, brought the GRAT to the attention of many by winning an IRS Tax Court case that sought to challenge the ability to set up a short-term GRAT. Their involvement with GRATs even led to the popularization of the term “Walton GRAT.”

Using a “Walton GRAT,” a taxpayer could put up to \$10 million worth of stock in a trust that pays back \$5 million each year plus a small interest payment, for two years. Anything that remains after those two annual distributions can pass to children free of estate taxes. The Walton case found that the funding of such a GRAT as described in this case is not considered a gift.

In contrast to the above, the “anti-Walton” GRAT provision in the new legislation would require GRATs to have a minimum term of ten (10) years, and for there to be a minimum gift considered to have been made on the funding of the GRAT that would have to be at least equal to either:

25% of the fair market value of the property placed in the GRAT; or \$500,000, depending upon the circumstances. Similarly to defective grantor trusts, this legislation will cause GRATs to be much less attractive as an estate tax avoidance technique. Many savvy families will be forced to enter into GRAT transactions immediately so as to be grandfathered in if and when the Act is signed into law.

YOU CAN TRUST THAT MULTI-GENERATIONAL FAMILIES WILL NOT BE HAPPY

One of the most controversial portions of the Sanders Plan is the requirement that long-term, multi-generational trusts be taxed occasionally as generations die.



As the law currently stands, long-term trusts can be established for beneficiaries and the trustee given the discretion to make distributions under an ascertainable standard, which will generally be for the “health, education, maintenance and support” of the applicable beneficiaries. This type of trust can benefit multiple generations without ever being subject to federal estate tax. This estate tax evasion even extends as new generations become beneficiaries.

The new legislation would cap a trust that would otherwise be exempt from the generation-skipping tax (GST) to a 50-year term and will cause pre-existing trusts to be deemed “terminated” 50 years after the passage date of the Act. If this new act passes, you will not catch a multi-generational trust saying “I’ll be back.”

What remains for pre-funded Dynasty Trusts is still unclear, but it seems that the intention of the law is clear and the IRS will have the authority to proscribe whatever regulations necessary to carry out the Act.

ANNUAL GIFTING TECHNIQUES CURTAILED

Beginning January 1, 2022, the \$15,000 per donee gift tax exemption will be limited to \$30,000 per donor with respect to certain transfers.

Under the law, the \$15,000 per year gift tax exclusion will be adjusted with inflation in increments of \$1,000. The maximum “per donor” amount for qualifying transfers will increase accordingly.

EXAMPLE 6:

Abraham’s \$15,000 per year annual gift tax exclusion increases to \$16,000, but he is still curious what his per donor amount is. Abraham’s per donor amount increased to \$32,000 in this case with reference to the below mentioned “limitation transfers.”

As most sophisticated planners know, the annual exclusion can be leveraged by giving trust beneficiaries withdrawal rights to withdraw contributions made to a trust for a period of time (known as Crummey Powers).

These contributions would qualify for the annual exclusion and thus reduce the amount of gift tax or exclusion used to fund a trust resulting in significant tax savings for trusts with multiple beneficiaries.

For example, a \$300,000 contribution to a trust with ten beneficiaries would result in no taxable gift if each beneficiary was given the right to withdrawal a pro rata portion of the contribution.

These limitation transfers, to which the \$30,000 per donor limitations apply, are as follows:

- a. A transfer into a trust;
- b. A transfer of an interest in certain family entities;
- c. A transfer of an interest in an asset that is subject to a prohibition on sale; and
- d. A transfer of an asset that cannot be immediately liquidated by the donee.

These limitations will also make it more difficult to transfer wealth from one generation to the next while still maintaining some degree of control over the use of such transferred assets.

EXAMPLE 7:

Phil and Susan have four children. They can presently gift \$120,000 of money or other assets into trusts. This amount is based upon the current \$15,000 per parent, per child rule.

After this law passes, Phil and Susan will only be able to transfer a total of \$60,000 into trusts for their children, while the other \$60,000 that they would have transferred might have to be given to the children as gifts or transferred into 529 College Plans.

DID THEY GIVE AWAY THE FARM?

Farms and conservation easements are the target of the final changes of the legislation.



The Act provides for greater benefits for estates that use their property for farming or another family business that will keep the business in the family for 8+ years after the death of the Grantor.

Currently, families that use portions of their property for “qualified” purposes, as described above, may reduce the applicable value for estate tax purposes to take into account the decreased value the property would be worth if based on its historical trade/farming use. This limit, which is currently \$1.19 million as indexed for 2021, stands to be increased to \$3 million under this Act, with the number still set to index with inflation.

Additionally, the maximum estate tax exclusion amounts for conservation easements increased dramatically. The limit, which used to be \$500,000, has quadrupled to \$2 million and may be increased even further in the future.

CONCLUSION

This piece of legislation, whose fate is still undetermined, could have a profound impact on millions of American families hoping to plan for the future. Many, especially given the Coronavirus pandemic and the government’s slow response, have not expected sweeping changes to estate tax laws to occur. Such families will need to act fast if they want to preserve their wealth in what could be one of the most significant estate tax changes in decades.



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Craig R. Hersch is a Florida Bar Board Certified Wills, Trusts & Estates attorney and holds his Florida CPA license, with over 30 years of experience in his practice. Craig is a partner at Sheppard, Brett, Stewart, Hersch, Kinsey & Hill and has created several trademarked processes tied to his estate planning and administration practice, including The Family Estate & Legacy Program and The Estate Settlement Program.



Craig has authored six books for clients: The Florida Estate Planning Guide, Selecting Your Trustee, Common Cents Estate Planning, Legal Matters When a Loved One Dies, Asset Alignment and Your Estate Plan and Common Cents Estate Planning II. His work has appeared in several professional journals, including The Practical Tax Lawyer, and The Florida Bar Journal, as well as being on the editorial advisory board for Trusts & Estates Magazine, the premier trade journal for estate planning attorneys, CPAs, and financial advisors. Craig also writes a weekly estate planning column that is published in Sanibel's Island Sun newspaper and on his firm's blog.

Craig is a multiple graduate of the University of Florida with accounting and law degrees and has provided his expertise as a continuing education lecturer for The Florida Bar and the Florida Institute of Certified Public Accountants.

Craig holds an AV Martindale Hubbell rating, the highest attainable by the independent national attorney rating service, has been selected as a Worth 100 Top Attorney and has been named to the Super Lawyers list every year since 2009, a highly-esteemed recognition given to no more than five percent of attorneys in Florida.

During his free time, Craig enjoys competing in triathlons, having finished an Ironman distance race and seven half-Ironman races over the last decade. Craig is married to his wife, Patti, and they have three daughters: Gabrielle, Courtney, and Madison.

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Michael B. Hill is a partner at Sheppard Law Firm. Michael is a Florida Board Certified Will, Trusts & Estates attorney concentrating his practice in estate and wealth preservation and business succession planning.



Michael has extensive tax, legal and technology skills, enabling him to create unique plans for meeting client's individual and family needs.

Michael is a double graduate of the University of Florida, receiving his Bachelor of Science in Accounting in 1998, and his Juris Doctor, with honors, in 2001. He is a member of the Florida Bar Association, the American Bar Association, and the Lee County Bar Association.

Michael and his wife, Jamie, have four children, Connor, Chase, Lindsay, and Caleb. In his free time, when there is any, Michael enjoys playing golf, working out, and watching most Gator sports. As an alumnus of the Fightin' Gator Marching Band, you may be able to spot him on Florida Field as a member of the Alumni Band, which marches at one home football game each year.

Hayley E. Donaldson

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Hayley E. Donaldson has been recently promoted to partner with the Sheppard Law Firm, working closely with estate planning attorneys Craig R. Hersch and Michael B. Hill. Hayley helps guide family members in the trust administration and probate process after the passing of their loved one.



Additionally, she assists clients with their tax and estate planning, drafting simple and complex wills, trusts, and related estate planning documents.

Hayley received her Juris Doctor from the University of Florida Levin College of Law, graduating first in her class. In law school she was a member of the Florida Law Review and Volunteer Income Tax Assistance (VITA) program which assists lower income individuals with their yearly tax returns.

Hayley is also a Certified Public Accountant (CPA) and worked previously as an Internal Audit Consultant for a national firm. Hayley has a Masters in Professional Accounting from the University of Texas and holds degrees in Accounting and Finance from the University of Miami. Raised in Fort Myers, she is also a proud graduate of the International Baccalaureate program at Fort Myers High School.

In her free time, Hayley enjoys running, swimming, and watching the Boston Red Sox.

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Andrew is an associate of Sheppard Law Firm, works closely with estate planning attorneys Craig R. Hersch and Michael B. Hill. Andrew assists clients with their tax and estate planning, drafting simple and complex wills, trusts, and related estate planning documents.



Andrew holds Bachelor of Science from Virginia Commonwealth University and Juris Doctor degree from the St. Thomas University School of Law. His non-legal experiences includes work in the real estate industry as a licensed Realtor and appraiser.

Andrew also worked as a regulator analyst for Dominion Energy where he administered contracts that connected generating facilities to the electric system. Andrew served as an Assistant State Attorney in southwest Florida before transitioning into a general trial practice concentrating on civil litigation and personal injury lawsuits.

Andrew is a member of the Florida Bar Association, and is also admitted to practice in the U.S. District Court, Middle District of Florida.

Andrew is married to Jennifer, who practices criminal law in southwest Florida. In his spare time, Andrew enjoys exercising, fishing, home improvement projects, and spending time with his family.