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To Our Clients and Friends

Memorandum

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CLIENT ALERT AND YEAR-END PLANNING MEMORANDUM

Executive Summary

- Millions of dollars in tax savings are available under current law, which is set to expire at the end of 2025 (and possibly earlier). We recommend locking in these tax savings while they are still available.
- Recent changes in the tax laws make it important to review your estate planning to determine whether some previously tax-efficient estate plans may now require updating to avoid unwelcome tax consequences or unintended dispositive effects.
- Historically low interest rates make certain strategies for tax-efficient transfers of wealth especially attractive right now. We encourage clients to consider these strategies.

Introduction. The last two years have brought new estate planning concerns as well as major opportunities for our clients. Since January 2018, major changes to the gift and estate tax landscape have taken effect, most significantly a temporary increase in the amounts taxpayers may give away free of Federal gift or estate tax (doubling to over $11 million per individual). This change opens a window of opportunity to save millions of dollars through tax-savvy lifetime gift and estate planning, but that window is set to close at the end of 2025 absent legislative action – and in our uncertain political climate, the window may disappear even sooner. This and other major developments are summarized below, along with some ways you may exploit these opportunities while they remain available.

Furthermore, while we always recommend that clients revisit and revise their estate plans at regular intervals (typically every five years or so) to keep pace with changes to their preferences, finances, and family circumstances, the new tax landscape adds new urgency for such a review. Many carefully constructed estate plans from before 2018 may be adversely affected by the new tax laws, and certain dispositions of property that previously made sense may no longer be necessary, desirable, or tax-efficient. **You should review your estate plan accordingly, if you have not already done so.**

Below is a summary of the most important factors to consider for your planning in the coming year, followed by some examples of available planning strategies and opportunities. **We encourage you to contact us to discuss your specific situation in detail. In any event, you should not take any planning actions without seeking the advice of a tax professional.**

Take Advantage of the Increased "Exclusion Amount" for Taxable Gifts. On December 22, 2017, the President signed into law legislation that made sweeping changes to the Internal Revenue Code (the "Code"). The most significant change for purposes of our clients' estate planning is the temporary increase, set to expire after 2025, of the exclusion amounts for Federal gift and estate tax purposes, doubling the lifetime exemption available to each taxpayer: rather than $5 million per person, adjusted for inflation since 2010, the exemption is now $10 million per person, similarly adjusted. As of 2019, for example, the IRS allows tax-free gifts and bequests totaling up to $11.4 million for individuals and $22.8 million for married couples, and these numbers will rise to $11.58 million and $23.16 million on January 1, 2020. **This means that, under current law, there is a roughly six-year window for clients to save millions of dollars in taxes with planned gifts, but given political uncertainties, this window may close much sooner.**

Likewise, the generation-skipping transfer ("GST") tax exemption amount (see the brief explanation below) also has doubled to match the gift tax and estate tax amounts, another significant tax benefit that will expire at the end of 2025 (absent earlier legislative action). **This presents an additional, equally temporary opportunity to potentially save millions of dollars in future taxes.**

Furthermore, the Treasury and IRS recently issued final regulations (effective November 26, 2019) to clarify that taxpayers who utilize the larger exclusion amounts prior to their expiration will not be subject to "clawback" for Federal estate tax purposes; that is, these tax savings would be "locked in" under current law even for taxpayers who outlive the scheduled sunset of these tax cuts after 2025. **Thus, for most clients it is highly advisable to take advantage of the larger exclusion amounts while they remain available, and it would be prudent to act sooner to mitigate the risk of future detrimental legislation.**

There are additional advantages to making lifetime gifts on an accelerated timeline:

- First, as noted above, the political future is uncertain. A new Congress and possibly a new President will take office in 2021 following next year's elections, and depending on electoral outcomes, this could spell an early end to these tax saving opportunities in a number of ways: Congress could decide to accelerate the sunset of the new Code provisions, or could vote to lower the exemptions to pre-2018 levels (or even lower levels), or could change the position regarding "clawback," or could even attempt to make any reduced exemptions retroactive to an earlier date – all circumstances where those individuals who have acted early may have reduced exposure to unfavorable tax consequences of future legislation or regulation.

- Second, gifts made earlier allow the recipients to benefit from subsequent appreciation on and income from the gifted property. Without such gifts, such appreciation and income would, of course, be part of the donor's taxable estate. (Note that there are also income tax considerations to account for, and any specific planning should be made in consultation with tax professionals.)

- Third, for our New York clients, under recently renewed changes to the New York Tax Law, gifts made within three years of a donor's death are added back into the donor's New York taxable estate, possibly subjecting these gifts to a state estate tax as high as 16%; earlier gifts have the benefit of starting this clock sooner. Assuming a donor survives the three-year period, lifetime gifts are then protected from New York estate taxes, and New York no longer imposes a separate gift tax (or a GST tax).

Please do not hesitate to reach out with any questions about these planning opportunities.

Generation-Skipping Transfers (GST). The generation-skipping transfer (GST) tax applies to transfers of assets to grandchildren or more remote descendants, or any other person more than 37.5 years younger than the individual making the transfer (these transferees are called "skip persons"). As of 2019, individuals have a GST tax exemption of $11.4 million to use, and married couples have between them $22.8 million (these numbers will rise to $11.58 million and $23.16 million on January 1, 2020). The GST tax rate, like the estate tax rate, currently is at 40%. Individuals who wish to make gifts to grandchildren or more remote descendants, or to trusts of which grandchildren or more remote descendants are beneficiaries, should strongly consider using their enlarged GST exemption while it remains an option.

Unlike the Federal estate tax, which is only levied on assets in excess of the estate tax exemption amount, distributions from a trust for the benefit of skip persons are taxable from the first dollar of distributions made. Unless GST exemption is allocated to trusts for the benefit of skip persons, such trusts are hit with a sizeable tax each time they make distributions to those individuals. In contrast, funds in GST-exempt trusts may be held to benefit multiple generations of descendants (subject only to state limits on the duration of a trust) without ever having to pay such taxes, giving these trusts a unique opportunity to grow without being diminished by estate or GST taxes. We are happy to discuss this and other ways to take advantage of the temporarily increased GST exemption amount.

Review Your Plan for Potentially Unwelcome Effects of Tax Reform. **Due to the new Code provisions, especially the larger exclusion amounts, all clients should review and consider updating their estate plans and lifetime planning**. Certain wills or trusts may contain "formula language" disposing of property with reference to the Code, including gifts measured as the amount of the donor's remaining unused gift or GST tax exemption; such gifts may no longer be consistent with the originally intended goal, and in some cases may have adverse tax consequences. **If your will or revocable trust contains one or more formula dispositions, please do not hesitate to contact us to review whether they meet your current wishes.**

Below are a few illustrative examples of plans likely to require an update:

- Certain estate plans for New York clients that include a "credit shelter" or "bypass" trust funded with the amount that can pass free of Federal estate tax could incur significant New York estate tax upon the death of the first spouse to die. This can be remedied with simple revisions to the funding formula for the trust.

- Certain plans may include a bequest of the amount of a client's unused GST tax exemption, which would now be funded with as much as $11.4 million (at 2019 levels; this number will increase annually with inflation and will be $11.58 million in 2020). This may still be desirable and efficient tax planning for very large taxable estates, but may produce unwanted results in comparatively smaller estates, such as a major reduction or elimination of bequests to other beneficiaries. For example, a formula bequest in a client's will of the GST tax-exempt amount to a long-term trust for the benefit of the client's descendants, with the balance of the client's assets passing to the client's surviving spouse, would now enlarge the bequest to the trust while diminishing the bequest to the surviving spouse. Whether or not this result is desirable will depend on individual circumstances, preferences, and asset levels, and should be discussed.

- Other estate plans with formula dispositions may now give a much larger share of the estate than originally intended to one or more beneficiaries (e.g., the children or descendants of a client), and this larger share may be inconsistent with a client's wishes (regardless of any tax considerations that also may apply).

Consider Strategies to Leverage Historically Low Federal Interest Rates. Federal interest rates are currently at historically low levels. Clients may wish to discuss lifetime planning strategies that leverage these low rates to allow transfers out of a taxpayer's taxable estate with little or no payment of gift tax, such as GRATs, sales and loans to grantor trusts, intra-family loans, charitable lead trusts and other planning vehicles. In many instances, it may be prudent to lock in low rates for a long-term planning benefit.

- *GRATs*. A "GRAT," or grantor retained annuity trust, is a special trust designed to allow transfers with little or no gift tax, usually to descendants or trusts for descendants, of the appreciation on invested trust funds exceeding an applicable Federal interest rate. To understand why low interest rates provide an optimal environment for use of GRATs, a bit of explanation may be helpful.

  To employ this structure, a grantor transfers property to a trust, which in turn is obligated to pay the grantor annuity payments for a specified number of years (the "GRAT term"). The amount of each annuity payment is determined in part by the value of property initially transferred, and in part by a Federal interest rate in effect at the time of the initial transfer used to calculate the "present value" of all such annuity payments. If the grantor survives the GRAT term, any property remaining after all annuity payments have been made passes to the remaindermen (e.g., the descendants or trusts that are the intended recipients of the tax-free transfer). Regardless of the value of the property transferred to the trust, or ultimately to the remaindermen, the value of the grantor's gift for tax purposes is generally zero (or nearly so), because the annuity payments are commonly calculated so as to have a "present value," for tax purposes, virtually equal to that of the gifted property interest at the time of transfer. In other words, as far as the IRS is concerned, the grantor is giving and getting the same (or nearly the same) value out of the GRAT.

  While GRATs may be structured in a number of ways (e.g., varying the GRAT term, staggering the amount of annuity payments to increase with time, etc.), current low Federal interest rates make them particularly attractive. The lower the interest rate, the less the GRAT is required to return to the grantor through annuity payments, which in turn increases the amount of appreciated trust funds that may pass to remaindermen tax free after the GRAT term if the grantor survives. As a simple illustration of a GRAT that may be "zeroed out" for gift tax purposes, if a grantor were to contribute property to a two-year GRAT in December 2019, and provide that upon termination the remainder of the GRAT would pass to a trust for the grantor's descendants, then, assuming the grantor survived the two-year GRAT term, any investment return in excess of 2% would pass to the trust for the grantor's descendants, fully sheltered from the gift and estate tax system.

- *Loans to Family Members*. Another relatively simple strategy for transferring wealth to family members (including skip persons) without generating gift, estate, or GST tax is the use of intra-family loans. To avoid having the IRS characterize a loan as a gift, a lender must charge a minimum annual interest rate published by the IRS each month (called the "applicable federal rate," or "AFR"), which varies based on the term of the loan and the frequency with which interest is compounded. In effect, this allows a borrower to invest borrowed funds and keep any returns on the borrowed principal in excess of the interest rate, allowing that "upside" to move out of the lender's taxable estate without using gift or GST exemption. As with GRATs, low interest rates make this technique a more attractive option. As of December 2019, the AFR (assuming semi-annual compounding of interest) is 1.60% for short-term loans (i.e., loans having a term of up to three years); 1.68% for mid-term loans (greater than three years and up to nine years); and 2.08% for long-term loans (over nine years). For certain clients it may be wise to lock in a loan at the current interest rate; see, however, the next strategy, which may offer additional advantages over a loan directly to family members.

- *Sales and Loans to Grantor Trusts.* Much like lending assets directly to a family member, a lender can also leverage low interest rates to transfer wealth to a trust for the benefit of family members. In addition to allowing the lender more influence over how assets will be used (by establishing the trust to conform with a dispositive plan), this can be an even more tax-efficient transfer strategy than direct lending. While interest payments on a loan to a family member are often taxable income to the lender, a trust can be structured under current law so that transactions between the trust and the grantor are disregarded for income tax purposes. Specifically, this would involve establishing a "grantor trust" – a trust which is disregarded as a separate entity from the grantor for *income tax* purposes, but not estate tax purposes. During the grantor's lifetime, trust income is reportable on the grantor's personal returns, but interest payments from the trust to the grantor are not taxable events. Furthermore, the grantor's responsibility for trust income taxes can be very useful for estate tax planning purposes, as it allows the assets in the grantor trust to grow tax free for the benefit of the beneficiaries, while any payment of income taxes by the grantor on the trust's behalf removes assets from the grantor's taxable estate without being taxed as a gift under current law.

  Another possible use of grantor trusts and debt instruments is the transfer of property that has been valued at a discount for tax purposes (e.g., interests in a closely-held family business, investment fund, or other entity). Clients who own such property, or who are considering utilizing the availability of discounts to lower their estate taxes, may consider a sale of property at the discounted price to a grantor trust in exchange for a promissory note (at the interest rates described above), allowing for a transfer of such property to a trust conforming to their dispositive plan while also avoiding current income tax exposure.

- *CLATs.* "CLATs," or charitable lead annuity trusts, may be an excellent alternative for clients with charitable intentions who also wish to pass on wealth to descendants or other beneficiaries. Much like a GRAT, a CLAT can be used to transfer to the trust's remaindermen, after a specified period of years (the "CLAT term"), any appreciation on trust property exceeding the applicable rate used to value annuity interests for tax purposes. The main difference is that annuity payments during the CLAT term are made not to the grantor, but rather to tax-exempt charities. Additionally, unlike a GRAT, a CLAT can be structured either as a grantor trust during the grantor's lifetime, or as its own separate taxpayer; each strategy may offer different tax advantages to clients and may be more appropriate in certain circumstances.

Other Lifetime Planning Strategies. You also may be able to obtain tax benefits with strategies that include the following:

- *Insurance Trusts*. An "Irrevocable Life Insurance Trust" or "ILIT" is a trust designed to be the owner and beneficiary of life insurance policies, most often on the life of a donor or on the joint lives of the donor and the donor's spouse. These trusts may purchase policies directly, or a donor may transfer ownership (and change beneficiary designations) of an existing policy to the trust. Assuming certain conditions are satisfied, the proceeds of an insurance policy are excluded from the donor's taxable estate (and later, the taxable estate of the donor's spouse), ensuring that up to nearly twice the amount of insurance proceeds are available for the use of the trust's beneficiaries after the death of the insured as potentially would be the case for proceeds received from policies owned directly by the insured. Another way to view it is that an insurance trust potentially nearly doubles life insurance coverage, or nearly halves the cost of insurance premiums each year, when estate taxes are taken into account. When a client owns or is contemplating ownership of one or more life insurance policies, the tax incentives for individuals with taxable estates (or who would have taxable estates factoring in the life insurance proceeds) strongly favor holding such assets in an insurance trust.

- *Annual Exclusion Gifts; Annual Exclusion Trusts*. The annual exclusion amount for gift tax purposes (increased periodically for inflation) is $15,000 in calendar year 2019 and will remain the same for 2020. Thus, each individual this year and next can give gifts of up to $15,000 per recipient without incurring gift (or GST) tax liability or using any gift (or GST) tax exemption. If spouses elect to split gifts for the year, they may collectively give up to $30,000 per recipient. Making these gifts does not diminish the lifetime gift tax exemption (i.e., the approximately $11.4 million currently available per person). These gifts can also be made to certain trusts (for one or more recipients).

- *529 Accounts (Now Available for Private K-12 School Tuition).* Due to recent changes to the Code, clients looking to make annual exclusion gifts to children, grandchildren, or other younger beneficiaries may have new reasons to consider a 529 account. Under the new rules, 529 account owners can now withdraw funds not only for qualified higher education expenses (as was the case before 2018), but also up to $10,000 annually per beneficiary for K-12 school tuition, for the first time allowing these funds to defray the costs of private schooling. Note, however, that some states, including New York, do not conform to these new Federal rules, which means that under current law state income tax benefits of a New York 529 account for New York taxpayers would be recaptured to the extent of any distribution for K-12 tuition.

- *Transfers Eligible for Valuation Discounts*. You may be able to achieve tax savings by funding and transferring interests that allow certain valuation discounts, which may be employed in various estate planning techniques (such as family limited partnerships and limited liability companies).

- *Qualified Transfers*. Payment of qualified tuition and medical expenses directly to an educational or medical service provider on behalf of an individual receiving the service are exempt from gift taxes (and do not count toward either the annual gift tax exclusion or lifetime exemption amounts).

Couples with a Non-U.S. Citizen Spouse. Under current law, while gifts to a U.S. citizen spouse are fully exempt from gift and estate taxes, the unlimited marital deduction does not apply to non-citizen spouses. Instead, there is an enlarged annual exclusion amount for gifts to a non-citizen spouse, which is adjusted annually for inflation. In 2019, the annual exclusion amount for such gifts rose to $155,000, and will rise again to $157,000 on January 1, 2020.

Same-Sex Couples. As a result of major court decisions regarding same-sex couples, the IRS introduced new procedures in 2017 to allow individuals to recalculate their remaining applicable exclusion amount or GST tax exemption, to the extent they had previously allocated exclusion or exemption to transfers that occurred while married to a person of the same sex. **Please contact us if you believe this relief may be applicable to you.**

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Please contact us with any questions you may have and if you wish to take advantage of these planning opportunities, including those which may no longer be available in the future.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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