SPECIAL REPORT

A CHANGING WORLD

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TRUSTS & ESTATES

By **Charles A. Redd**

Playing Chess With the Feds

A dizzying array of tax proposals keeps practitioners on their toes

The year 2021 presented a dizzying array of possible alterations to federal tax laws. It began with a flurry of legislative activity compressed within a 4-day period at the end of March. Sen. Bernie Sanders (I-Vt.) introduced the "For the 99.5% Act,"[1] followed shortly thereafter by Rep. Brad Pascrell's (D-N.J.) H.R. 2286[2] and Sen. Chris Van Hollen's (D-Md.) " STEP Act."[3] On April 28, President Joe Biden published (in the form of a "Fact Sheet") his "American Families Plan." Then, on May 28, the Treasury Department issued its *Green Book*,[4] traditionally an annual compilation of Treasury's favored proposed tax law revisions.[5] Taken together, these Spring 2021 proposals sought, among other things, to reduce the estate and gift tax basic exclusion amount,[6] increase the estate, gift and generation-skipping transfer (GST) tax rate,[7] increase the maximum marginal income tax rate,[8] increase the long-term capital gains tax rate,[9] restrict grantor retained annuity trusts (GRATs)[10] to eliminate an individual's ability to create a zeroed-out, short-term GRAT, limit the effectiveness of an allocation of GST exemption[11] to 50 years and eliminate the step-up in basis to fair market value at a property owner's death[12] or establish a deemed sale regime applicable to many lifetime gifts and transfers at death.

Fall 2021 brought renewed Congressional efforts to change various tax laws. On Sept. 13, the House Ways and Means Committee floated a heart-stopping proposal that included reducing the estate and gift tax basic exclusion amount by 50%, largely treating, for estate and gift tax purposes, irrevocable "grantor trusts" as if they were revocable, eliminating valuation discounts for non-business assets, increasing income tax rates, imposing surtaxes and greatly increasing required minimum distributions (RMDs) from and limiting additions to, defined contribution qualified plans and individual retirement accounts exceeding $10 million in value. On Sept. 27, the proposal matured as H.R. 5376, sponsored by Rep. John Yarmouth (D-Ky.), consisting of 2,468 printed pages of legislative text. The Sept. 27 version of H.R. 5376 was unable to gain any traction in Congress for a variety of intertwined political reasons apparently revolving around Sen. Joe Manchin (D-W. Va.) and Sen. Kyrsten Sinema (D-Ariz.).

On Oct. 28, the House Committee on Rules released its Halloween surprise—a draft copy of a substantially scaled-back version of H.R. 5376—seemingly in a feverish effort to unify Democrats in both the House of Representatives and the Senate. The Oct. 28 version of H.R. 5376 itself was superseded, without notice or warning, by yet another version on Nov. 3. Insofar as estate planning and estate and trust administration are concerned, the Nov. 3 version is mostly unchanged from the Oct. 28 version. The Nov. 3 version (as of the date of this writing, the latest version) contains almost none of the provisions of the Sept. 27 version summarized above, and so the "panic" in the estate-planning community that had accompanied the Sept. 27 version seems at least temporarily to have subsided.

The main provision of the Nov. 3 version of H.R. 5376 that, if enacted, would impact most ultra-high-net-worth estate-planning clients would apply for taxable years beginning after Dec. 31, 2021 and would impose, in addition to regular income tax, up to an 8% "surcharge" on what the Nov. 3 version refers to

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as "high income individuals, estates and trusts." Also, the Nov. 3 version, like the Sept. 27 version, would incorporate new rules pertaining to RMDs from, and additions to, certain qualified plans and IRAs.

We're left with massive uncertainty. It would be irresponsible for estate planners and their clients blithely to proceed as if none of the components of the Sept. 27 version of H.R. 5376 could be resurrected. Reflecting on not-too-distant experience, we know significant changes in tax law can be dredged up from old proposals, inserted into pending legislation and signed into law with little or no warning. Recall that subsection (f) of Internal Revenue Code Section 1014 and IRC Section 6035 (the basis consistency rules) were adapted from several prior years' *Green Books* and added to the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015[13] within a day or two before President Obama signed it into law on, and with an effective date of, July 31, 2015.

Opportunities Under Current Law

At this time, and for the indefinite future, as a result of the 2017 Tax Act,[14] individuals have a greatly enhanced, historically high basic exclusion amount.[15] This large basic exclusion amount is scheduled to revert to its pre-2017 Tax Act level on Jan. 1, 2026[16] and could be reduced by legislation at any time before that date. If legislation to reduce the basic exclusion amount is enacted in 2022, it could be given retroactive effect as far back as Jan. 1, 2022—a risk prospective donors may wish to consider.[17] As we counsel clients and design estate plans in anticipation of a possible overhaul of the tax law that could include any of the features that were discussed last year, we should endeavor to position clients so they're able, immediately or on very short notice, to take advantage of opportunities under current law while at the same time minimize potential damage that a given modification of the tax law could cause.

Lifetime Gifts

Those having significant wealth who wish to maximize their use of the basic exclusion amount now in place may wish to consider expeditiously making lifetime taxable gifts that fully absorb the basic exclusion amount. Individuals making gifts sooner rather than later will remove from their gross estate more appreciation and income generated by the gifted property, which could be highly beneficial regardless of when the basic exclusion amount declines. Advice to make a gift, however, should often be tempered by the caveat that a basis step-up on the owner's death with respect to the gifted asset will be forfeited. Additionally, a large gift donor whose net worth would have been safely under the current basic exclusion amount may regret having precipitously parted with the gifted property (and, in so doing, perhaps having lost some basis step-up opportunities) if reduction of the basic exclusion amount before Jan. 1, 2026 doesn't materialize. Also, a client may be receptive to making a large gift, now or on short notice but may think it important to structure such a gift so the client retains the possibility of enjoying, directly or indirectly, some economic benefits from the gifted property.

A better approach is a gift in trust for children and more remote descendants.

Outright gifts. Many clients whose net worth easily exceeds the current basic exclusion amount and who view impending reduction, by legislation, of the basic exclusion amount as inevitable will be amenable to making immediate gifts to enable full use of their basic exclusion amount. Outright gifts accomplish the goal of basic exclusion amount utilization, subject, though, to the possibility that such legislation is made retroactive to a date preceding the gifts. Such gifts are conceptually simple and generally quick and easy to implement but have no substantive estate planning benefits.

Gift in trust. A better approach is a gift in trust for children and more remote descendants. The longer the term, the more efficacious. A large gift to a long-term irrevocable trust fully using a client's basic exclusion amount, to which the client's GST exemption is allocated, puts potentially very substantial value in a vehicle that for the indefinite

future escapes estate tax, gift tax and GST tax and enables the fine-tuning of income tax consequences (basis step-up using formula general powers of appointment for beneficiaries and minimizing income taxes for the trust and its beneficiaries through the making of judicious distributions). Under current law, the benefit is maximized if the trust is a "grantor trust" for income tax purposes.

Defined value gift. Some individuals whose net worth is well above the current basic exclusion amount and are otherwise prepared to proceed with a gifting program may fear the possibility of tax legislation slashing the basic exclusion amount with a retroactive effective date that precedes the date of a gift. Such an individual might consider making a defined value gift, which could be outright or in trust, the terms of which gift would provide that any amount of the gift in excess of the donor's basic exclusion amount, as finally determined for federal tax purposes, shall pass in a manner not triggering a requirement to pay gift tax.[18] The excess amount, if any, could pass in a manner qualifying for the gift tax marital deduction or charitable deduction, to a zeroed-out GRAT or to an incomplete gift trust.[19]

The decision whether to elect QTIP treatment could be deferred to as late as Oct. 15, 2023.

Disclaimer. Another approach such an individual might consider would be to make an outright gift and structure it so that, if disclaimed,[20] the gifted property will return to donor. A disclaimer, if implemented, could be designed as a formula disclaimer.[21] This technique would extend the time within which a decision whether, or to what extent, to use the donor's basic exclusion amount could be made.[22] This strategy could be used in conjunction with a gift in trust but would be considerably more complicated due to questions about whether a trustee, consistent with its fiduciary duty to beneficiaries, can properly reject property contributed to the trust.

QTIP Trust

A particularly attractive maneuver for a married client who's ready to make an immediate irrevocable transfer to use the currently available basic exclusion amount but is worried about the risk of legislation that erodes the basic exclusion amount being made retroactive would be to create and fund an inter vivos qualified terminable interest property (QTIP) trust.[23] The decision whether to elect QTIP treatment (thereby causing property transferred to the trust to qualify for the gift tax marital deduction and causing the transfer of such property not to be a taxable gift) could be deferred to as late as Oct. 15, 2023.[24] If the client observes before Oct. 16, 2023 that the basic exclusion amount has been reduced but not retroactively, the QTIP election wouldn't be made, and so the donor's basic exclusion amount, before it was reduced, would have been effectively deployed. If, before Oct. 16, 2023, the basic exclusion amount is reduced and such reduction is made retroactive to a date preceding the funding of the trust, the QTIP election would be made, causing the gift tax marital deduction to shelter the transfer to the QTIP trust from gift tax. If the basic exclusion amount isn't reduced, then, again, no QTIP election would be made.

Self-Settled Trust

A client who doesn't want to lose the opportunity fully to use the current basic exclusion amount may be concerned less about a possible retroactive decrease in the basic exclusion amount and more about losing all the economic benefits of the property the client is considering gifting. Such a client could consider creating and funding an irrevocable trust in a self-settled asset protection trust jurisdiction,[25] with an independent trustee, for the concurrent benefit of the client and the client's descendants living from time to time (and, perhaps, the client's spouse). The trustee would have sole, absolute and unfettered discretion to make, or not make, income and principal distributions among the beneficiaries. The client would have no power of appointment and no power under any circumstances to appoint, as a successor trustee, a "related or subordinate party."[26] In the absence of an understanding before trust funding between the settlor and the trustee regarding distributions to be made, employing this technique should result in a

completed gift by the client[27] (using the client's basic exclusion amount) and no inclusion in the client's gross estate of the value of the trust property.[28]

SLAT

A married individual in a similar position but for any reason unable or unwilling to use the self-settled trust model summarized in the preceding paragraph could create and fund a spousal lifetime access trust (SLAT). A SLAT is substantially similar to a self-settled trust as described above, but, instead of the settlor being a discretionary beneficiary at the outset, the settlor's spouse occupies that role. Unless the SLAT is established under the law of a self-settled trust jurisdiction, the settlor shouldn't be designated in the governing instrument as a discretionary beneficiary in the event the spouse predeceases the settlor, but perhaps an independent trust protector could be given the wholly discretionary authority to bring the settlor into the trust as a beneficiary in that event. Note, however, that, if the marriage later dissolves, one of the principal objectives of the SLAT (keeping the economics of the gifted property in the donor's household) also dissolves. In addition, if a SLAT is created by each spouse for the other, take care to avoid application of the reciprocal trust doctrine.[29]

GRIT

Finally, a client wanting to retain benefits from gifted property should avoid the temptation to engage in a transaction that would ostensibly use the basic exclusion amount but would result in value being included in the gross estate. An example would be establishment of a grantor retained income trust (GRIT). The transfer of property to a GRIT would constitute a taxable gift of the entire value of the property transferred—with no reduction in the value of the gift by an amount equal to the then-present value of the donor's retained income interest because that interest wouldn't be a "qualified interest."[30] Thus, such a transfer would appear to be an effective and efficient mechanism by which to take advantage of the current enhanced basic exclusion amount. At the same time, the donor would benefit from the income generated by the GRIT throughout the GRIT's stated term. In the final "no clawback" regulations, however, space is explicitly reserved for, and the preamble to those regulations makes cryptic reference to, a not-yet-developed anti-abuse rule that, when finalized, would apparently cause "transfers subject to a retained life estate or other retained powers or interests" not to be within the protective scope of those regulations.

Endnotes

1. Senate Bill 994, March 25, 2021. Sen. Kirsten Gillibrand (D-N.Y.), Sen. Sheldon Whitehouse (D-R.I.), Sen. Chris Van Hollen (D-Md.) and Sen. Jack Reed (D-R.I.) were co-sponsors.
2. March 29, 2021.
3. The "Sensible Taxation and Equity Promotion Act of 2021" (STEP Act). There's proposed legislative language, but the STEP Act hasn't been formally introduced. In addition to Sen. Van Hollen, Sen. Cory Booker (D-N.J.), Sen. Bernie Sanders (I-Vt.), Sen. Sheldon Whitehouse and Sen. Elizabeth Warren (D-Mass.) signed on to the STEP Act discussion draft.
4. The formal title of the *Green Book* is *General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals*.
5. Treasury didn't publish a *Green Book* throughout President Donald Trump's administration.
6. Internal Revenue Code Section 2010(c)(3) defines the term "basic exclusion amount." The current basic exclusion amount is $12.06 million. It could perhaps decline to $5 million, indexed by the cost-of-living adjustment referenced in IRC Section 2010(c)(3)(B) or to $3.5 million. In the absence of an applicable tax law change, this large basic exclusion amount will decrease on Jan. 1, 2026 pursuant to the law in effect before enactment of "An Act To Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," P.L. 115-97 (Dec. 22, 2017). Section 2010(c)(3)(C).
7. The current rate under IRC Section 2001(c) is effectively a flat rate of 40%. That rate might increase to 45%. A maximum rate of 65% could be imposed.
8. The current maximum marginal rate under IRC Sections 1(j) and 1411 is 40.8%. For individuals with taxable income of $400,000 or more, that rate could reach 43.4%.
9. The current rate under Sections 1(h) and 1411 is between 0% and 23.8%. For individuals with taxable income of $1 million or more, long-term capital gains could be taxed at the maximum bracket for ordinary income.
10. The current grantor retained annuity trust rules are set out in IRC Section 2702 and Treasury Regulations Section 25.2702-3.
11. *See* IRC Section 2631.
12. The current rules providing for basis step-up at death are set out in IRC Section 1014.
13. P.L. 114-41.
14. "An Act To Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," P.L. 115-97 (Dec. 22, 2017).

15. *Supra* note 6.
16. Section 2010(c)(3)(C).
17. *See United States v. Carlton*, 512 U.S. 26 (1994).
18. *See Estate of Christiansen v. Commissioner*, 130 T.C. 1 (2008), *aff'd* 586 F.3d 1061 (8th Cir. 2009); *Estate of Petter v. Comm'r*, T.C. Memo. 2009-280, *aff'd* 653 F.3d 1012 (9th Cir. 2011); *Hendrix v. Comm'r*, T.C. Memo. 2011-133; *Wandry v. Comm'r*, T.C. Memo. 2012-88.
19. Perhaps this strategy would fail to protect a donor from the deleterious result of retroactive reduction of the basic exclusion amount. Unlike the situation in the defined value provision cases, the defined value in this scenario, on the date of the gift, is impossible, even theoretically, to determine because there's an essential fact that's unknown and unknowable on that date, that is, the amount of the donor's applicable credit amount. But, then, would such logic, extended to its end, require invalidation of all "zero-out-the-estate-tax" marital deduction formulas in wills and revocable trust instruments because, theoretically, a retroactive change in the IRC could occur at any time?
20. *See* IRC Section 2518.
21. *See Estate of Christiansen v. Comm'r, supra* and Treas. Regs. Section 25.2518-3(d), Example (20).
22. If there were an "understanding" between the donor and the donee that the donee would disclaim on the donor's request, might the gift be incomplete until the 9-month period within which a qualified disclaimer could be made has expired?
23. *See* IRC Section 2523(f).
24. The election must be made, if at all, on a timely filed gift tax return. *See* Section 2523(f)(4)(A) and Treas. Regs. Section 25.6081-1.
25. There are currently 19 states that have some form of asset protection trust legislation: Alaska, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming.
26. *See* IRC Section 672(c).
27. Private Letter Ruling 9837707 (Sept. 11, 1998) and PLR 200944002 (July 15, 2009). PLRs may not be used or cited as precedent. IRC Section 6110(k)(3). *See also* Rev. Rul. 77-378.
28. PLR 200944002 (July 15, 2009).
29. *See United States v. Estate of Grace*, 395 U.S. 316 (1969).
30. *See* Section 2702.