EMBRACING UNCERTAINTY IN

PLANNING IN VOLATILE TIMES

By

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"It's tough to make predictions, especially about the future."

Attributed variously to Niels Bohr, Yogi Berra and others,
but probably originated by an anonymous Dane before WWII
per quoteinvestigator.com/2013/10/20/no-predict/

I. SOME PERSPECTIVES ON FLUX AS A PERMANENT BACKDROP

A. Personal Perspectives

1. Recollection of comment made to me as a young T&E lawyer that I had entered a "sleepy" end of the law.

2. Contrary to that comment, estate planning has probably been subject to more constant change over my career than any other area.

B. Federal Tax Gyrations

1. Since I started practicing, Congress has tinkered with the federal tax system on a continuing basis – I count some 35 volumes on my shelf summarizing federal tax enactments (some more than one Act), starting with ERTA in 1981, most (all?) affecting federal wealth transfer taxation.

2. Déjà vu All Over Again – The estate and GST taxes have already been "repealed" at least once in our lifetimes, under a 10-year phaseout set forth in the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), setting forth

    a. A phased-in increase in the unified credit, with the exemption equivalent rising from $675,000 to $3,500,000,

    b. A sunset of the taxes as of December 31, 2009 and,

    c. A repeal of stepped-up basis rules as of 2010 (with carryover basis subject to certain exemptions).

3. EGGTRA, however, came with a built-in sunset of all of its provisions – that is a complete reinstatement of the pre-2001 structure – effective as of 2011.

4. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010

    a. Extended EGTRRA's sunset date to December 31, 2012,

    b. Increased the exemption equivalent to $5 million (indexed for inflation),

c. Reduced the top transfer tax rate to 35%,

d. Introduced spousal portability of the decedent's unused exemption amount, and

e. Allowed an election for 2010 decedents to be subject to carryover basis rules instead of estate and GST taxes.

5. Congress finally sunsetted the sunset under the American Taxpayer Relief Act of 2012 (enacted in January, 2013), "permanently" reinstating the estate tax but with a 40% top tax rate.

C. <u>Massachusetts Changes Affecting Estate Planning</u>

1. 1975 replacement of inheritance tax with estate tax.

2. 1986 substantial overhaul of Mass. estate tax.

3. 1992 enactment of Mass. sponge tax (subject to phase-out of free-standing tax 1992-1996).

4. 1998 Mass. Prudent Investor Act.

5. 2003 Mass. "decoupling" of sponge tax from the disappearing federal estate tax, tying the Mass. estate tax to the Code as in effect on December 31, 2000.

6. 2003 DOR Directive 03-2 authorizing separate Mass. QTIP election.

7. 2005 Mass. Principal and Income Act.

8. 2009 Mass. Uniform Probate Code (generally made effective as of 2012).

9. 2010 overhaul of Mass. homestead law.

10. 2012 Mass. Uniform Trust Code.

D. <u>Current Uncertainties in Estate Planning</u>

1. Trump Administration one-page fact sheet distributed April 26, 2017 provides, among other income tax items, to "Repeal the death tax."

2. This is consistent with the Trump campaign platform, which had also included (in various places)

   a. Taxation of capital gains held until death, with the first $10 million tax-free as under current law to exempt small businesses and family farms,

   b. A proposed phaseout of the tax exemption on life insurance interest for high-income earners (designated as revenue-raiser to help pay for tax cuts), and

   c. A disallowance of contributions of appreciated assets into a private charity established by a decedent or a decedent's relatives "to prevent abuse."

3. These skeletal proposals leave six major questions unanswered:

   a. Will repeal occur?

      (1) The current House might well pass a bill for estate tax repeal, though even here there is no certainty.

      (2) In the Senate, it is hard to see a repeal of the estate tax garnering any support among Democrats.

      (3) There are now 52 Republicans (a majority), but in general, the Senate effectively requires a vote of 60 Senators, because that is the number needed to shut off a filibuster.

      (4) A Republican majority could pass tax legislations through the reconciliation process, but under the "Byrd rule," such legislation could not be structured so as to increase the deficit after ten years – hence the crazy quiltwork of sunset provisions in many recent tax statutes.

      (5) But query whether a Republican majority might invoke the "nuclear option," repealing a minority's right to filibuster and thereby permitting enactment by a simple majority.

   b. Will there be a gift tax?

      (1) No longer needed as a backstop to the estate tax.

(2) But commonly seen as necessary to safeguard a progressive income tax from free shifting of assets to lower-bracket taxpayers or shifting gain assets to taxpayers with usable losses.

(3) This can include consideration of state income taxation, which would be undermined by possible gifting of income-producing assets to trusts sited in no-tax state.

(4) But query how effective as a backstop is a gift tax with a $5,490,000 exemption amount.

c. Will there be a generation-skipping transfer tax?

(1) Unlike the gift tax, the GSTT is purely a backstop to the estate tax and has no real income tax implications.

(2) So repeal of the GSTT should follow any repeal of the estate tax.

d. Will capital gains accrued at death be taxed?

(1) Will the tax be triggered at death (as in Canada) as a kind of substitute "death tax?"

(2) Or will the tax be triggered only in a later taxable sale or exchange?

(3) Will there be an exemption from post-death taxation (a retention of step-up in basis)–

(a) for the first $10 million or some other amount?

(b) only for small businesses and farms (perhaps paralleling the special valuation rules for real estate of IRC §2032A)?

(c) determined on a per-taxpayer, per-couple, or per-family basis?

e. What should we make of the proposal to disallow a contribution of appreciated assets to a private charity established by decedent or his or her relatives?

(1) Presumably the proposal is for the disallowance of a deduction rather than a prohibition of any contribution itself.

(2) If the estate tax is to be repealed, presumably the disallowance relates to the income tax, not the estate tax.

(3) Perhaps the proposal is to limit a deduction to the taxpayer's basis, but that is already the general rule under IRC §170(e)(1)(B)(ii) for contributions to a private foundation except for marketable stock described in IRC §170(e)(5).

(4) But if there is an abuse here, why is it an abuse only in relation to decedents?

(5) Might the proposal intend to deny to a decedent's successors a double benefit of a step-up in basis and a deduction of the full value of an asset (marketable securities) contributed to a private foundation?

(6) Or to prevent avoidance of the taxation of gains accrued at death?

(7) In either case, how long would the taint last, and would it be traced to new assets acquired in a nontaxable transaction?

f. What about the proposal to phase out the tax exemption on life insurance interest for high-income earners?

(1) This proposal has received very little press – is it still in play?

(2) If so, what does it mean?

(a) is the thought to tax the ongoing inside build-up of value in life insurance policies held by high-income individuals, or

(b) to tax gross life insurance proceeds when received by such individuals, or

(c) to tax the gain on such proceeds?

(d) how would it be applied to life insurance owned indirectly by HNW individuals through trusts or business entities?

4. A New Level of Uncertainty – Does Trump's accommodation with Democrats in recent weeks to lift the debt ceiling and deal with so-called "dreamers" represent a new political direction, and if so, what does it portend for tax legislation?

5. Massachusetts Estate Tax Overhaul?

a. Layered on top of possible federal changes is the possibility of a substantial overhaul of the Mass. estate tax.

b. Currently pending on Beacon Hill (apparently in Committee) is a bill that would:

(1) Reinstitute a freestanding Mass. estate tax, not masquerading as a sponge tax, with rates from 10% to 13% of the taxable estate.

(2) Provide a Mass. exclusion of 50% of the federal exclusion amount.

(3) Provide an *additional* exclusion of the value of the decedent's principal residence up to 50% of the federal exclusion amount.

(4) Provide for portability of the decedent's unused exclusion to a surviving spouse.

II. WHY UNCERTAINTY IS THE PLANNER'S FRIEND

A. Overall Opportunities to Help Clients

1. In general, uncertainty presents an enhanced opportunity to be valuable to our clients.

2. In particular, it is an opportunity to help provide a sense of stability and steadiness to clients when they feel uncertain.

3. That is, an opportunity to provide a sense of perspective to clients based on our career experience and interactions with numerous clients.

4. It is also an opportunity to demonstrate skill as a planner to build as much flexibility into the planning as possible.

B. Opportunities for the Planner

1. Changes in law provide reasons to interact with clients and provide perspectives and advice.

2. This is especially significant for lawyers, whose interactions are often episodic and transactional, as contrasted with other advisors with more continuing contact.

3. In the short run, prospective changes in the law may provide legitimate reasons to tinker with a client's planning or with planning documents.

4. Any actual changes in the law will compel review and revision of estate-planning documents.

5. Change is especially good for new practitioners, who instantaneously can become as expert on the law as older veterans.

6. In the long run, any repeal of transfer taxes may provide an opportunity to focus more the planners' root functions as trusted family advisors, as opposed to technical tax advisors.

C. Estate Planning Focus Areas Beyond Transfer Taxes

1. Counseling clients as to best ways to transfer wealth to desired recipients:

    a. Family vs. charitable recipients.

    b. Lifetime vs. testamentary transfers.

    c. Outright transfers vs. transfers in trust.

d. Special issues for blended families.

2. Asset protection planning:

   a. For clients in position to transfer wealth.

   b. For beneficiaries.

3. Charitable gift planning.

4. Planning for possible lifetime incapacity.

5. Special needs and Medicaid planning.

6. Income tax planning:

   a. Optimization of basis step-up (if any.)

   b. Planning for capital gain taxation at death or thereafter.

   c. Planning for retirement assets.

7. Intrafamily disputes – resolution, or prosecution or defense.

8. Planning for closely-held businesses.

9. Planning for life insurance and annuities as possible investment alternatives.

10. Planning for minor children – selection of guardians.

11. Planning for the migratory client – clients with multistate and multinational connections.

III. <u>LIFETIME GIFTING, ANYONE?</u>

A. <u>Gifting under Present Uncertainty</u>

1. Possible repeal of estate tax should have only a modest effect on present lifetime gifting.

2. Annual exclusion gifts – Gifts within the $14,000 annual gift tax exclusion remains the one “freebie” within the transfer tax system, so clients should continue to avail themselves of it.

3. Lifetime exemption gifts – Gifts within the lifetime exemption (now $5,490,000 per taxpayer) might or might not remain attractive:

   a. From a tax perspective, a client would not be made worse off for having made a tax-free lifetime gift if any of the current tax proposals were enacted.

   b. But if the client's desire to make the gift is purely tax-driven – if he or she otherwise would prefer to hold and control the assets until death – then possible repeal of the estate and GST taxes would present a significant reason to refrain from current gifting.

   c. On the other hand, a tax that can be repealed can also be re-enacted should the political winds shift again, and this reality might sustain the tax attractiveness of a major lifetime gift for the tax-motivated client.

4. Fully-taxable gifts (beyond the $5,490,000 exemption)

   a. Making gifts that entail paying an actual tax to the IRS has always been a tough sell to clients, even where it has made tax sense (given the opportunity to remove the gift tax itself from the tax base and reduce total transfer taxes).

   b. The possible repeal of the estate tax makes this a doubly tough sale – no one wants to be the schmuck who pays a gift tax on a transfer that would be tax-free at death.

B. <u>Gifting After Any Estate Tax Repeal</u>

1. If gift tax is retained

   a. In the absence of an estate tax, any gifting of assets beyond the lifetime exemption, triggering an actual gift tax liability, presumably would only have resulted from a planning error or an IRS upward valuation of the assets (which is really a kind of error, given the possibility of transfers by valuation formula).

   b. Tax-free gifting within any lifetime exemption might still be attractive for income tax reasons, to shift the income of the gifted assets to family members in lower brackets (or to trusts sited in no-tax states).

c. Tax-free gifting within any lifetime exemption might also be attractive as a hedge on a possible future reduction in the lifetime exemption amount – the idea being to use it while we know we have it.

d. The possibility of tax-free gifting within any lifetime exemption otherwise would provide a test of the appetite of a client (and of clients in general) to make gifts for non-tax reasons – out of love and affection.

e. As life expectancies lengthen, some wealthier clients might find it desirable to let their children enjoy some of their inheritance before such children are themselves old.

f. Tax-free gifting within any annual exclusion presumably would be attractive for the same reasons that would apply to gifting within any lifetime exemption, but even more so.

g. The logical vehicle for transfers by the wealthiest Americans would be to multigenerational dynasty trusts, *not funded by gift* but rather funded at death, anticipated to lock wealth out of the transfer tax system, perhaps in perpetuity, in the face of any re-enactment of such system.

h. Estate freeze arrangements that minimize the use of lifetime exemption presumably would also continue to be attractive:

(1) Grantor retained annuity trusts (GRATs).

(2) Sales to intentional grantor trusts.

(3) Partnership freeze arrangements.

(4) Charitable lead trusts (CLTs).

2. If gift tax is also repealed

a. If the gift tax were repealed along with the estate tax, gifts of any size would become attractive for the same reasons suggested above for gifts within any annual exclusion or lifetime exemption.

b. We could expect a torrent of gifting by the wealthiest Americans, seeking to make hay while the sun shines.

c. We could also expect an intensified focus on income planning, with gifting of income-producing assets to family members in lower brackets or of gain assets to family members with usable losses – perhaps coupled with later gifts back to the original donor.

d. The logical vehicle for gifting by the wealthiest Americans again would be to multigenerational dynasty trusts, funded *either* lifetime or at death, anticipated to lock wealth out of the transfer tax system, perhaps in perpetuity, in the face of any possible re-enactment of such system.

C. Coordination with Basis Step-up Rules

1. Whatever the transfer tax regime, a client's gift strategy will need to be coordinated with the current and expected basis step-up rules.

2. Repeal or partial repeal of basis step-up at death could have the following effects:

   a. Further encouragement of lifetime gifting, as it would reduce or eliminate a strong tax reason to retain assets until death.

   b. If law provides for a deemed disposition at death, encouragement to effect tax-free swaps of an individual's low-basis assets for high-basis assets held in any grantor trust (the opposite of the incentives existing today).

3. Conversely, retention of the current basis step-up rules would continue to encourage the retention of low-basis assets and the gifting only of high-basis assets.

IV. BUILDING MAXIMUM FLEXIBILITY INTO PLANNING ARRANGEMENTS AND DOCUMENTS

A. Issues Posed by Uncertainties in Federal (and State) Tax Laws

1. Importance of monitoring changes in federal (and state) law, and reviewing estate planning every few years.

2. Possible document interpretation issues for documents structured by reference to tax concepts – e.g., funding formulas tied to the amount that could pass tax-free by virtue of the federal unified

credit or marital deduction and funding tied to the GST exempt amount.

3. Possibility of client becoming legally incompetent before planning can be "fixed."

B. Solutions in General

1. The "Gumby" estate plan – Now, more than ever, documents need to be constructed with lots of flexibility, plenty of options, and ample opportunity for midcourse corrections.

2. Incompetency problems

   a. Incorporating into plan specific arrangement whereby other persons may amend crucial features of revocable trust document – amendment by donor's guardian, attorney-in-fact (under specific authority in durable power of attorney), or independent trustees or outside "protector" of trust (under express amendment provision).

   b. Adding in other flexibility features (see below).

3. Trust interpretation problems

   a. No way around problem of carefully reviewing trust funding language to see if it will achieve sensible results even in the absence of a federal estate or GST tax.

   b. But note possible "saving" of formulas also tied to a Mass. marital amount, which might still "work" without a federal estate tax

      (1) Example: reference to smallest amount that would minimize the *sum* of federal and state estate taxes if passed to marital trust.

      (2) If federal estate tax is posited to be zero in all cases, we still have a workable formula which now is solely a function of state estate taxes.

   c. We might expect states to apply a generic "fix" to estate planning documents that continue to refer to obsoleted federal tax terms, but a client-specific fix will remain preferable.

d. Compare ERTA §403(e)(3), which effectively invited states to enact statutes to reconstrue trusts with "maximum allowable" marital deduction formulas in light of ERTA's 1981 transition from a deduction limited to the larger of $250,000 or the adjusted gross estate to an unlimited marital deduction.

C. <u>Building Flexibility into Irrevocable Estate Planning Documents (Irrevocable Either *Ab Initio* or by Donor's Death) – Safety Valves</u>

1. Spousal "second-look approach – funding trust pursuant to surviving spouse's disclaimer of outright distribution to spouse upon first spouse's death.

2. Giving surviving spouse a general power of appointment over marital trust.

   a. Generally no estate tax effect to the extent the marital trust would be includible in surviving spouse's estate in any event.

   b. Can maintain flexibility as to marital deduction amount by qualifying as QTIP trust by deferring surviving spouse's withdrawal power until 15 months from deceased spouse's date of death (latest date when estate tax returns are due).

   c. Pre-portability, the general power would apply only to assets in excess of the *greater* of the federal and Mass. exemption equivalent amounts (so as to not waste either unified credit).

   d. Post-portability, the general power can fixed by reference to the Mass. exemption equivalent – that is, the surviving spouse can hold a power over the balance of the federal credit-shelter share (generally now the pool of assets in excess of $1,000,000 but not in excess of $5,490,000) – without wasting the unused exemption amount.

3. Trustee "second-look" approach – funding credit-shelter trust to the extent that trustees waive QTIP election with respect to marital trust (a *Clayton* election).

4. Discretion vested in trustee to "spray" (or withhold) distributions – perhaps coupled with nonbinding letter of wishes set forth outside of formal trust document.

5. Discretion in trustees to move the place of administration and/or change the law governing the trust instrument.

6. Amendment power vested in independent trustees or trust protector.

7. Explicit power for trustees to decant to a new irrevocable trust, or equivalently an explicit power to make distributions to a trust for one or more beneficiaries (buttressing the evolving Mass. "common law" power to decant).

8. Limited powers of withdrawal for spouse or other beneficiaries ("5 and 5" powers).

9. Lifetime special powers of appointment for beneficiaries – potentially in favor of anyone but the beneficiary himself (or his or her creditors).

10. Testamentary special powers of appointment for beneficiaries – potentially in favor of anyone but the beneficiary's own estate (or its creditors).

11. Power of spouse and/or other beneficiaries to remove and replace trustees.

12. Flexibility to reinclude assets in a beneficiary's gross estate (to obtain basis step-up or apply that beneficiary's GST exemption):

    a. This assumes that we still have a GST tax or we still have a step-up in basis.

    b. If we have a step-up in basis without an estate tax, Congress would need to rewrite the cross-references in IRC §1014 referring to property includible in the decedent's gross estate.

    c. Reinclusion might be accomplished by either of the following means:

        (1) By authorizing an independent trustee to grant the beneficiary a general power of appointment (i.e., a testamentary power).

        (2) By expressly inviting a beneficiary to exercise a limited testamentary power of appointment in a manner triggering the "Delaware" tax trap under

IRC §2041(a)(3) causing inclusion of the appointed property in the powerholder's gross estate.

(a) this works by the powerholder creating a general lifetime power of appointment in a permissible appointee or appointees, causing the triggering of a new rule-against-perpetuities measuring period, and the consequent postponement of vesting, under the laws of many states, including Massachusetts.

(b) though somewhat arcane, it can be neater than authorization to create a general power, as it (A) vests control and responsibility in the beneficiary whose estate will be "charged" with inclusion of appointive property, rather than in a trustee who needs to worry about fiduciary responsibilities, and (B) pushes the risks inherent in holding a general power down another generation.

(c) if IRC §2041(a)(3) were repealed as part of a repeal of the estate tax, query whether IRC §1014 would still retain a reference to it or to some parallel rule.

D. <u>Particular Flexibility Arrangements for Lifetime Irrevocable Trusts</u>

1. General desirability for donor to maintain access to assets gifted to trusts and to be able to unwind the otherwise irrevocable gift, or otherwise to cause reinclusion in his or her gross estate.

2. Self-settled trusts – access through the front door — self as permissible beneficiary

   a. Traditionally in Massachusetts and in most states, a gift to a trust would not treated as "completed" for tax purposes if the trustees had any discretion to make distributions back to the donor; rather, the trust assets would remain includable in he donor's taxable estate.

   b. This is because under state law the donor's creditors might have access to such self-settled trust to the maximum extent of such trustee discretion.

c. In principle, a donor would retain indirect access to the assets, because he or she might run up debts knowing that his or her creditors could be satisfied from trust assets.

d. Though there is some contrary tax authority, suggesting that this result does not always apply, it would be unwise as a planning matter to assume a completed gift to a self-settled trust in a "traditional" state.

e. It might be possible to give a party (probably *not* a trustee) a power to add the donor to the list of eligible beneficiaries at some time after the inception of the trust.

f. A more reliable way to effect a completed a gift to a self-settled trust would be to create the trust under the laws of a state which expressly exempts such a trust from creditor claims (such as Delaware, New Hampshire or Rhode Island) or a foreign jurisdiction with such an exemption.

g. But note that actual distributions back to the donor generally would run counter to good tax planning, on account of the reinclusion of the assets in the donor's gross estate, as long as we still have an estate tax, though reinclusion might be helpful if we retain a basis step-up rule.

h. Also note possible vulnerability under state fraudulent transfer laws and analogous federal bankruptcy rules.

3. Spousal limited access trusts (SLATs) – access through the back door – spouse as permissible beneficiary

a. A SLAT should provide a means to unwind an irrevocable transfer without resort to the laws of a jurisdiction offering special protections.

b. Under a SLAT, the trustees could make distributions to the donor's spouse, who would be free to return those assets to the donor without income or transfer tax consequences, as long as the donor is a U.S. citizen.

c. Again, as long we still have an estate tax, transfers from the trust to the spouse generally would run counter to good tax planning, except to the extent that basis step-up outweighs any detriment of inclusion in gross estate.

d. Like all planning arrangements, SLATs does present some risks:

(1) risk of marital disharmony or divorce.

(2) risk of application of reciprocal trust doctrine if each spouse creates a trust for the other, resulting in uncrossing of the trusts and treatment of trusts as created by donor for his/her own benefit.

e. Reciprocal trust doctrine can be avoided by varying the two trusts as much as possible, including possibly:

(1) Different beneficiaries (i.e., spouse and children vs. children only).

(2) Different trustees.

(3) Different powers of appointment (or no POA in one trust). *See Levy v. Commissioner*, T.C Memo 1983-453.

(4) Different standards of distribution (ascertainable vs. fully discretionary).

(5) Allowance or prohibition of unitrust conversions.

(6) Different trustee appointment and removal provisions.

(7) Different types of assets.

(8) Different dates of trust creation.

4. Flexibility to reinclude assets in donor's gross estate (to obtain basis step-up):

a. This assumes that we still have a step-up in basis and (as discussed above) that IRC §1014 is rewritten to continue to point to estate tax inclusion rules.

b. A named disinterested person (probably *not* a fiduciary) might be authorized to give to the donor one or more powers that would cause inclusion in his or her gross estate under IRC §2038, as proposed by Jonathan Blattmachr and Martin Shenkman in "Drafting for the Possibilities of

Trump Estate Tax Legislation," *Tax Management Estates, Gifts and Trusts Journal* (Jan.-Feb. 2017, Vol. 42, No. 1).

5. Grantor trust powers

   a. Whether not a donor might seek to unwind a lifetime trust in its entirety, he or she should be given the express ability to shut off powers that create grantor trust status.

   b. This is because the retention of the liability for a trust's income taxes largely is an advantage in eroding the estate-tax value of the donor's assets and bolstering the value of the lifetime trust to the beneficiaries.

   c. So the value of grantor trust status may be significantly nullified if there is no federal estate tax.

   d. However, grantor trust status might still provide significant income tax advantages, including the ability of the grantor to engage in tax-free transactions with the trust, such as the ability to swap out low-basis assets for high-basis assets. See III.C.2.b on page 12, above.