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Monday, 26 March 2018 **WRM #18-12**

TOPIC: Legacy Planning Post-Tax Reform - Part 2: New Transfer Tax Exemptions – Use 'Em or Lose 'Em.

MARKET TREND: Increased transfer tax exemptions offer new legacy planning opportunities for high net worth families for a limited time.

SYNOPSIS: The 2017 tax reform legislation (the "Tax Act") doubled the gift, estate, and generation-skipping transfer ("GST") tax exemptions effective January 1, 2018. The increased exemptions, however, are only temporary and sunset on December 31, 2025, at which time they drop back to $5 million (adjusted annually for inflation from 2010 through 2025). The temporary nature of the increased exemptions, coupled with the possibility that a different Administration and Congress could decrease the exemptions earlier, makes it imperative that higher net worth families act now.

TAKE-AWAYS: Families who continue to be affected by the federal estate tax can use the enhanced transfer tax exemptions to address that exposure and implement substantial lifetime planning over the next several years. Taking advantage of these enhanced exemptions should not be the sole focus going forward, however, as traditional estate planning techniques, such as irrevocable life insurance trusts and spousal lifetime access trusts, will continue to offer practical legacy planning benefits to individuals at all levels.

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Beginning January 1, 2018, the Tax Act doubles the base exclusion amounts for gift/estate and GST taxes (collectively, "**transfer taxes**") from $5 million to $10 million, which is inflation-adjusted annually from 2010 using a new "chained" consumer price index. These increased exemptions expire on December 31, 2025 or possibly sooner if legislative changes occur the interim.

Transfer Tax Exemptions – Summary of Changes

Effective Date	**Until Dec. 31, 2017**	**Effective Jan. 1, 2018**	**Effective Jan. 1, 2026**
Gift/Estate & GST Tax Exemptions	**$5.49 million** ($5 million base, inflation-adjusted from 2010 to 2017)	**$11.18 million** ($10 million base, inflation-adjusted from 2010 to 2018)	Approx. **$5.5 million** ($5 million base, inflation-adjusted from 2010 to 2026)

To take maximum advantage of the higher exemptions while they exist, individuals should aim to use as much of the increased amounts as possible, subject to their individual circumstances.

> *Example*: Harold and Wilma have accumulated an estate of $50 million during their marriage but have not made prior taxable gifts, meaning they can jointly give $22.36 million to their descendants in 2018 under the enhanced transfer tax exemptions. Harold and Wilma create an irrevocable dynasty trust and fund it with a joint gift of $11 million. They make no further gifts and in 2026 the exemption increase expires, dropping their combined transfer tax exemptions back to about $11 million. Even though Harold and Wilma made a substantial gift in 2018, it did not apply towards the increase in their transfer tax exemptions.

OLDIES BUT GOLDIES, SUPERCHARGED

While temporary, the increase in the transfer tax exemptions opens the door to significant planning opportunities for higher net worth individuals and their families. The ability to front load irrevocable trust funding allows taxpayers to take full advantage of the new transfer tax exemptions **and** remove the subsequent appreciation from the taxpayer's estate. As there is a time-value to money, proactively planning today using the expanded exemptions generally will produce far better results than sporadic, modest planning.

Dynasty Trusts. Irrevocable dynasty trusts are efficient tools for passing family assets through successive generations while simultaneously providing asset protection, avoiding fractionalization of asset ownership (in closely held business interests, real estate, etc.), and providing continued unified asset management. Dynasty trusts take full advantage of both the enhanced gift/estate tax exemption and the GST tax exemption, allowing family wealth held in the trust and the growth thereon to pass from generation to generation without estate or GST tax at each successive generation.

> *Example*: Henry and Willow have accumulated a net worth of $100 million, consisting primarily of a closely held business that they would like to pass to their descendants. The business has a current fair market value of $75 million. Neither Henry nor Willow has made prior taxable gifts. They create an irrevocable dynasty trust and fund it with interests in the closely held business having a proportionate value of about $29.8 million, but with application of a 25% marketability and minority discount, having a fair market value of $22.36 million. Combining the large gift with the discounts allows Henry and Willow to take maximum advantage of their enhanced transfer tax exemptions.

Structuring the dynasty trust as a "grantor trust" will transfer additional wealth through the grantor's payment of the trust's income taxes, as the grantor's tax payments are not deemed a gift to the trust. Larger exemptions can enhance this approach, since the larger base of gifted assets presumably produces greater income.

<u>Installment Sales to Grantor Trusts</u>. With an installment sale, the grantor sells assets to a grantor trust in exchange for an installment note for a specified term of years. The grantor typically makes a "seed" gift to capitalize the grantor trust so it can meet its note obligations, often equal to 10% of the value of the assets to be sold. The increased transfer tax exemptions permit a larger seed gift to the grantor trust that can support a more substantial sale. For example, a seed gift of an individual's $11.18 million federal gift tax exemption could capitalize a dynasty trust for a sale of assets of up $111.8 million. Alternatively, the larger exemptions give the flexibility to structure a transfer of assets with a much smaller note.

> *Example*: From the above example, assume Henry and Willow want to transfer 49% of their $75 million business to the dynasty trust, which would have a proportionate value of $36.75 million and a fair market value of $27,562,500 after the 25% discount. In 2018, they can give $22.36 million of business interests and take back a promissory note in the principal amount of $5,202,500 for the sale of the remaining interests they want to transfer. Compare to 2017, when Harold and Willow could only make a gift of $10.98 million and would have needed to take back a note for over $16.58 million for the balance of the business interests.

- **Practice Point**: Installment sales provide the sellers with a predictable income stream and only transfer future appreciation in the assets sold, returning the initial value of the transferred assets to the seller. This may assist in planning for individuals who have concerns about parting with too much wealth.

Installment sales also can be structured as a so-called "**SCIN**," which are installment sales with an automatic cancellation provision that terminates the repayment obligation if the seller dies before the end of the note's term. The self-cancellation feature arguably removes the note's value from the seller's estate for estate tax purposes.[1]

Irrevocable Life Insurance Trusts ("ILITs"). The increased transfer tax exemptions can prefund an existing or new ILIT, which eliminates many of the administrative hassles associated with making annual gifts to the trust to cover premiums and sending withdrawal notices to the beneficiaries. Prefunding may work well with a guaranteed or high cash value product to produce better policy results. Gifting the larger exemption allows a policy to be prepaid, possibly enhancing its performance, or for a guaranteed product, locking-down the guarantees.

Spousal Lifetime Access Trusts ("SLATs"). Spouses who are reluctant to make a large lifetime gift because they may need the funds in the future can consider using non-reciprocal SLATs to take advantage of the increased exemption amounts. With a SLAT, the donor makes a completed gift to an irrevocable trust that benefits the donor's spouse and descendants. The donor can continue to have indirect access to the assets through distributions made to the spouse, which alleviates concerns about giving away too much wealth.[2] A larger gift by one spouse also allows the couple to mitigate the risk of creating reciprocal SLATs.[3]

Completed Gift Domestic Asset Protection Trusts ("Hybrid DAPTs"). Individuals reluctant to make large lifetime gifts also may consider using a Hybrid DAPT to use their enhanced transfer tax exemptions. Unlike traditional DAPTs, a Hybrid DAPT is structured as a completed gift from the donor to the trust and qualifies for use of the gift and GST tax exemptions. The donor, however, is **not** named as an initial beneficiary and does **not** retain a power of appointment or other powers that could pull the assets into his or her estate at death. Rather, the hybrid DAPT allows for the donor to be added as a beneficiary in the future, providing a safety net if the donor or his or her spouse need future access to the funds. Hybrid DAPTs are grantor trusts, which may further enhance the benefits of this technique.

Completed Gift DINGs, NINGs and INGs. While so-called DINGs, NINGs, and INGs (collectively referred to as "**INGs**") traditionally are structured as incomplete gift non-grantor trusts, they also can be created as completed gifts for gift tax purposes, qualifying for use of the enhanced transfer tax exemptions. INGs are designed to address state income tax exposure (not federal income tax) by establishing the trust in a state with low or no state income taxes.[4] Using the enhanced exemptions to fund an ING trust as a completed gift may preserve even more capital gain and other trust income.

OUT WITH THE OLD: UNWINDING PRIOR TRANSACTIONS

Families with estates above **and** below the new transfer tax thresholds may derive benefits from applying the increased transfer tax exemptions to exit prior legacy planning transactions, including:

Exiting Installment Sales to Grantor Trusts. Families with outstanding installment sales can use the increased exemptions to exit transactions before the promissory note's maturity date.

> *Example*: In 2015, Hugh sold his closely held business to a grantor trust he created for his descendants in exchange for a $10 million promissory note. The note provides for annual interest payments over 20 years, with a balloon payment due in 2035. Hugh wants to take advantage of the enhanced transfer tax exemptions and does not use the note payments to support his lifestyle. Hugh could use the increased transfer tax exemptions to make a gift to the grantor trust, which the trustee could decide to use to prepay the note in full.

Exiting Split Dollar Agreements. As with installment sales, families who have entered into split-dollar loans to finance life insurance premiums also can use the increased exemptions to make gifts to the ILIT that the ILIT trustee could decide to use to pay off the loan.

Exiting a DAPT. If a donor no longer has a need to access all or even some of the assets in a traditional DAPT (i.e., one that is included in the donor's estate at death), the DAPT can be unwound in whole or in part by decanting the trust assets into another irrevocable trust (such as a dynasty trust) for the benefit of the settlor's spouse and/or descendants as a completed gift.

TAKE-AWAYS

Families who continue to be affected by the federal estate tax can use the enhanced transfer tax exemptions to address that exposure and implement substantial lifetime planning over the next several years. Taking advantage of these enhanced exemptions should not be the sole focus going forward, however, as traditional estate planning techniques, such as irrevocable life insurance trusts and spousal lifetime access trusts, will continue to offer practical legacy planning benefits to individuals at all levels.

NOTES

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[1] See *WRMarketplaces No. 15-09* and *No. 15-31* for a discussion of installment sales and SCINs.

[2] See *WRMarketplace No. 15-07* for a discussion of SLATs.

[3] See *WRMarketplace No. 17-49* for a discussion of the reciprocal trust doctrine.

[4] See *WRMarketplace No. 16-36* for a discussion of ING trust planning.