Ask the Experts: Prepare for Possible Sunset of High Estate Tax Exemption

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What Makes Fiduciary Trust Distinctive?

Experienced professionals focused on our clients' best interests

Expertise	Breadth, depth and focus to help clients realize their goals	• Highly experienced trust & estates legal, financial planning, and investment teams • 20+ years average industry experience of professionals • Access to advantageous New Hampshire trust laws
Wealth Focus	A private firm focused on our clients' best interests	• 139-year history of integrity and financial stability • Private ownership and free from misaligned objectives • $30 billion in assets under supervision • Only provide wealth management-related services
Personal Service	Proactive approach customized to client needs	• 98% average annual client retention rate for over a decade • Clients have direct relationships with senior professionals • Partner with external attorneys, accountants, RIAs & other professionals
Flexible Offering	Service offering adapted to client needs	• Corporate trustee, co-trustee, and trust administration-only services, including directed and delegated trustee arrangements • Donor-advised fund program with advice and custom features available • Custody services with principal and income as well as tax-lot accounting, backed by robust technology, personal service, and flexibility

* Based on Fiduciary Trust of New England, combined with its Massachusetts affiliate, Fiduciary Trust Company

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Topics for Discussion

- Historical background on the exclusion and the opportunity to gift
- Cautionary Considerations in Gifting
  - Ensuring client cashflow
  - Anti-clawback Regulations
  - Reciprocal trusts
  - State tax planning – income and estate/gift
- Opportunities
  - Marital Trust Planning
  - Family Entities
  - Allocation of GST Exemption
  - Trans-Generational Planning
  - Funding ILIT Trusts
  - Trustee/Trust Jurisdiction selection

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Historical background

Historical Estate Tax Dates

1797
First U.S. estate "transfer" tax

1916
Modern estate tax dates back to World War I

1976
Unified Estate and Gift Tax System, introduced GST Tax

1980
Step up in basis

1981
Unlimited marital deduction and QTIP; tuition and medical expenses

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Estate tax rates and exclusion amounts have changed over time

1941 to 1976
Highest estate tax rate: 77% tax on amounts over $10 million

2000
Lowest exclusion amount this century: $1 million with 35% tax

2011
Portability election introduced

2013
Maximum 40% tax rate

2025
Highest exclusion amount: $13.99 million (excluding 2010)

Gift tax rates and exclusion amounts have also changed over time

1977 to 1981

Highest gift tax rate: 70% on amounts over $5 million

2000

Lowest exclusion amount this century: $675,000 in 2000/2001 with 55% tax over $3 million

2004 to 2010

Gift and estate tax exclusions were not the same from 2004 to 2010

2013

Maximum 40% tax rate since 2013

2025

Highest exclusion amount: $13.99 million

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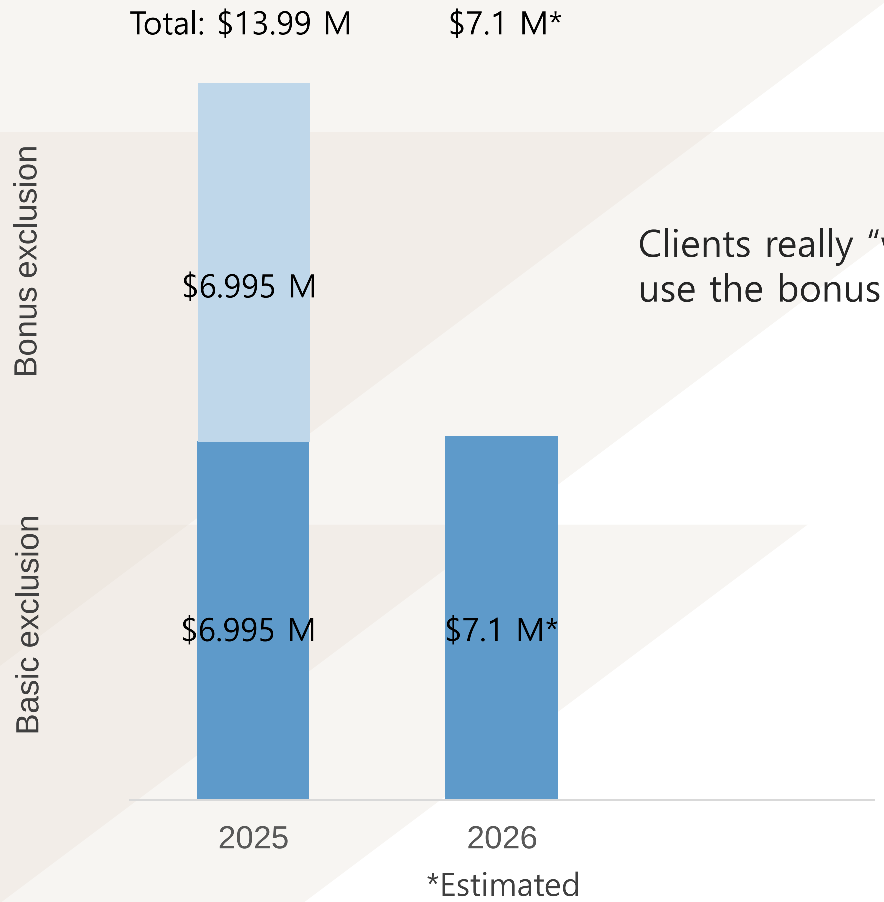
How the current exclusion works



Clients really “win” if they use the bonus exclusion

Cautionary Considerations in Gifting

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To Gift or Not to Gift: Cautionary Considerations in Gifting

- Does gifting align with client goals?
  - How you think of goals may not match how your client thinks of goals

- Does client have capacity to gift?
  - Cash flow needs are important
    - How will gift impact client cash flow?
    - A long-term financial plan should be prepared
      - Incorporate the expected
      - Provide room for the unexpected
  - High balance sheet is not the same as capacity to gift

- Giving up control can be emotionally challenging
  - Relationship with money and others

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Clawback and Anti-clawback Rule

Will taxes the donor never expected to pay be clawed back from the donor's taxable estate?

What if the exclusion goes down? Is there clawback?

How the federal estate tax is calculated (very simplified view):

	Assets in decedent's estate
minus	**Deductions (marital, charitable, expenses, etc.)**
equals	**Taxable Estate**
plus	**Lifetime taxable gifts**
equals	**Taxable Estate plus Taxable Gifts**
calculate	**Gross Estate Tax**
minus	**Applicable Exclusion Amount/DSUE**
equals	**Tax Due**

Note: Although not illustrated above, calculation does give credit for any gift taxes paid during lifetime.

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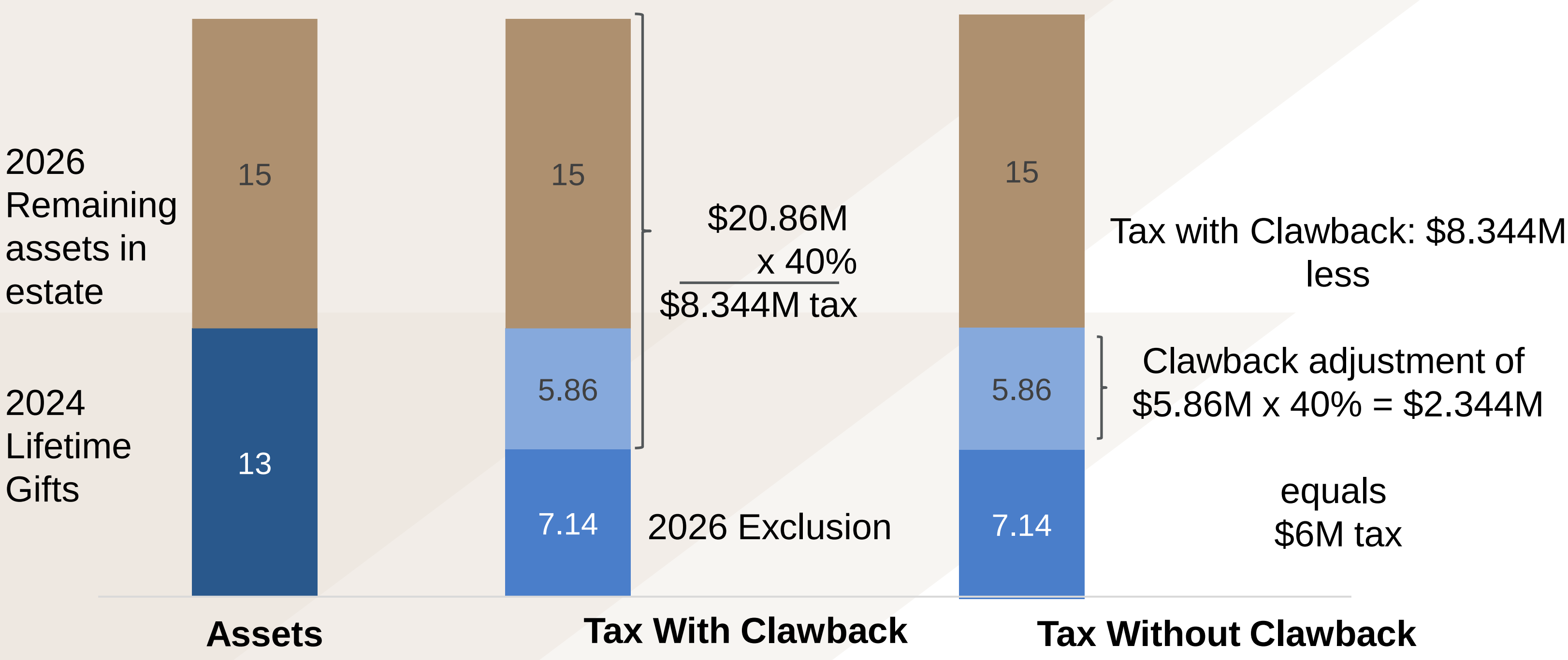
Clawback Calculation – Why it Matters

What if the amount of lifetime gifts are larger than the current exclusion because the exclusion decreased since the gifts were made? Will tax be due on gifts that were covered by the bonus exclusion before?

Example: Julie's Estate, NH Resident



Special Anti-clawback Rule to the rescue (2019)

Treasury Regulation 20.2010-1(c)

Final Regs issued 11/26/2019

Essentially: the *bonus* exclusion utilized for post-2017/pre-2026 gifts will be allowed to calculate the donor-decedent's federal estate tax liability when there are post-2017/pre-2026 gifts

Result: Estate of donor is not taxed on ***completed*** gifts that were exempt from gift tax when made.

Caution: be aware of Anti-Abuse Exceptions to the Special Anti-clawback rule (Proposed Regs)

Anti-Abuse Exceptions to the Special Anti-clawback rule

2022 Proposed Regs addressed potential abuses of the Special Anti-clawback rule

Proposed Regulation Sec. 20.2020-1(c)(3) dated 4/27/2022

Proposed Regs have exceptions for **completed** gifts that are **includible** in the donor's estate (testamentary transfers), among other exceptions.

- Differentiate between
  - "completed" gifts that are treated as "adjusted taxable gifts" and not includible in the donor's gross estate
  - "completed" gifts that are treated as "testamentary transfers" and includible in the donor's gross estate

Ask: Was it a bona fide transfer where the donor "absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of this possession and all of his enjoyment of the transferred property"? *Commissioner v. Church's Estate*, 335 U.S. 632,645 (1949).

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Anti-Abuse Exceptions to the Special Anti-clawback rule

Includible Gifts under the 2022 Proposed Regs include:

- Donor retains beneficial use of the property:
  - Retained life estate
  - Retained powers from Code Sections 2035 through 2038 and 2042
    - 2035: 3-year ETIP
    - 2036 – retained possession or enjoyment, right to income, or power to designate who has right to possess or enjoy property or income
    - 2037 – transfer takes effect at death (just need to survive the decedent); includes reversionary interests
    - 2038 – revocable transfers
    - 2042 – proceeds from life insurance on decedent (if decedent has incidents of ownership or is beneficiary)
  - Gifts made by enforceable promise outstanding at donor's death (legally binding promissory note – Revenue Ruling 84-25)
  - Gifts subject to special valuation rules of 2701 and 2702 (corporations or partnerships)

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Anti-Abuse Exceptions to the Special Anti-clawback rule

Includible Gifts under the 2022 Proposed Regs include:

- *18-month rule:* If donor, or someone acting with or on his/her behalf, gives up rights to above types of gifts within 18 months of the donor's death, then they are includible as well
  - Exception: if the rights expire per the terms of the original instrument of transfer then the 18-month rule does not apply
- *5% Savings Clause:* If there was a 5% or less reversionary interest (at the time of the transfer) then the interest will not be subject to clawback

Result: If "gift" falls under an exception to the Special Rule, there is clawback

Note: Income tax "defective grantor trusts" not mentioned

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Opportunities

Warning: Reciprocal Trust Doctrine

- **Doctrine:** If two or more transferors make transfers in trust giving each other a benefit or control under the trust, the doctrine will identify the recipient of a benefit of power under the trust as the true transferor. *US v. Grace's Estate*, 395 US 316 (1969).

- **Example:**
  - **Facts:** Spouse 1 creates a Trust A for the benefit of Spouse 2 and their descendants. At the same time, Spouse 2 creates Trust B for the benefit of Spouse 1 and their descendants.
  - **Result:** Spouse 2 is treated as the transferor of Trust A (will be included in Spouse 2's gross estate) and Spouse 1 is treated as transferor of Trust B (will be included in Spouse 1's gross estate).

- **Factors:**
  - Creation and funding of trusts were interrelated; and
  - Settlor's in "approximately the same economic position"

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State Level Consideration: Estate and Gift Tax

- **Takeaway Point:** There is no one-size fits all solution for clients given state level considerations.
- **Outright Gifts:** While gifts in trust offer many non-tax advantages, it can also avoid creating state-level estate tax issues for beneficiary who lives in an estate jurisdiction.
- **State Tax Consequences:**
  – Connecticut is the only state with a gift tax, so gifting can reduce later state estate tax liability.
  – Warning: Some jurisdictions have lookback periods that can not only increase the state estate tax liability, but could make it non-deductible.

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State Level Consideration: Income Taxes

- **Takeaway Point:** There is no one-size fits all solution for clients given state level considerations AND they will notice income tax impacts immediately.
- **Outright Gifts:** Once assets are owned by the beneficiary, that beneficiary will be subject to taxes on its income.
- **Gifts in Trust:** Structured correctly, setting up a trust in the right jurisdiction and with the right provisions can have the planning pay for itself immediately.

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Gifting Techniques Without Transferring Assets

- **Problem:** Many clients will have an estate tax issue after the sunset, but don't have the assets to gift assets away and lose access to.

- **Solutions:**
  - Martial Trusts
  - Decontrol entity
  - GST Allocation

Martial Trusts: Triggering Taxes Now

- **Section 2056:**
  - Code provisions provides an unlimited marital deduction for property passing outright or in certain trusts
  - This provides estate tax deferral in that taxes will be owed when surviving spouse dies with assets in that spouse's estate or assets are gifted or a deemed gift
- **Restructure Marital Trusts:**
  - Can make distribution from trust to spouse to make gift
  - Can modify trust so it no longer qualifies for marital deduction, resulting in a deemed gift so exemption is used and asset it out of survivor's estate
- **Warning:** Getting asset out of survivor's estate could forfeit step-up in basis on asset.

Decontrol Entity

- **Two birds with one stone:**
  - Owner having voting rights and/or other control has value for estate and gift tax purposes.
  - After *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (2017) and its progeny, IRS has position that control can cause estate tax inclusion under Section 2036(a)(2).

- Section 2704 and general gift tax principles has loss of voting rights and/or control is a gift of value.

- **Technique:** Give up control and report value of lost control as a gift, will decrease value of interest for estate tax purposes while keeping economic stake.

- **Warning:** Section 2036(a)(2) has a three year lookback so not effective for deathbed planning.

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Late GST Allocation

- Certain planning techniques often leave assets that are not exempt from generation-skipping transfer (GST) tax:
  - Grantor Retainer Annuity Trust (GRAT)
  - Qualified Personal Resident Trust (QPRTs)
  - Irrevocable Life Insurance Trust (ILIT)
- Technique: File return to allocate GST exemption prior to sunset which will be based on current value of trust but will make it exempt going forward.

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Trans-Generational Planning

- Look at existing trusts for opportunities to use other family member's exemption.
- Non-Exempt GST Trusts could be distributed to non-skip beneficiaries and resettled by them to be an exempt trust.
- Trusts with unfavorable state income tax treatment (especially testamentary trusts) could be gifted to a beneficiary where upon resettlement in trust it could reduce state income tax liability.
- Distributions do not need to be outright as trusts can have general power of appointment added with another party having veto power on its exercise.

Irrevocable Life Insurance Trusts (ILITs)

- Designed to own life insurance and keep the death benefit out of the grantor's estate
  - An irrevocable trust with an independent trustee (recommended)

- Mechanics:
  - Annual funding – enough to cover the life insurance premium
    - Annual exclusion gifts may be allowed
  - Super funding – enough to cover premiums for many years to come
    - A potential use for exemption
    - Funds in trust can be invested until needed for premium payments
    - May be able to use current year annual exclusion gift up to limit
    - Gift and income tax returns likely required

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Trust Jurisdiction Selection

- Trusts are powerful planning tools, but what jurisdiction the trust is established in (where trustee or administration occurs) makes a substantial impact.

- Non-Tax Factors
  - No rule against perpetuities
  - Directed trusts
  - Decanting statute
  - Asset protection
  - Robust and modern statutory law
  - Predictable and efficient court system

- Tax consideration: Will jurisdiction seek to impose state income taxes because of location of trustee or place of administration?

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