Tax Time Bombs:

Defusing the Estate Tax Before the Exemption Sunsets and Navigating Inherited IRA Landmines

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"The only difference between death and taxes is that death doesn't get worse every time Congress meets."

-- Will Rogers

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2021: a year of proposals, but will any changes be enacted?

- "For the 99.5% Act"
- "Sensible Taxation and Equity Promotion (STEP) Act"
- Then, on September 12th: the House Ways and Means released proposed legislation:
  - Would cut estate/gift/GST exemption in half
    - $11.7m to $5m, indexed for inflation ($6,020,000)
  - Would cause inclusion of "Grantor Trusts" created post date of enactment in Grantor's estate
  - Would eliminate valuation discounts in gifts of passive entities

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House Ways & Means (cont.)

- Other proposals not included in September proposal:
  - Carryover basis at death instead of step-up
  - Unrealized capital gains tax at death
  - Wealth tax
- Effective date?
  - January 1, 2022, versus date of enactment

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Fall 2021…

- September 12th: Looks like Estate Tax exemption Sunset could accelerate.
- October 28th: President Biden releases “Build Back Better” Framework
  - Notably: Silent on Estate Tax
- November 3rd: Congress released proposed Build Back Better Act:
  - No change to the Estate Tax exemption
  - No change to the estate/gift valuations
  - No grantor trust inclusion
  - No unrealized capital gains tax

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“It’s tough to make predictions, especially about the future.”

-- Yogi Berra

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Federal Estate & Gift Tax

- If September's proposal *had* become law, these techniques would be gone:
  - Sales to Intentionally Defective Grantor Trusts (IDGT)
  - Qualified Personal Residence Trusts (QPRT)
  - Irrevocable Life Insurance Trusts (ILIT)
  - Grantor Retained Annuity Trusts (GRAT)

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Federal Estate & Gift Tax (cont.)

- With Estate Tax reform less likely in the short term, clients have a second chance

- The 2017 Tax Cuts & Jobs Act (which doubled the Estate Tax exemption amount) expires on December 31, 2025
  - Exemptions will drop back down to $5 million, indexed for inflation (unless Congress takes action before then)

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Second Chances…

- Making large gifts now won't harm estates after 2025 84 Fed. Reg. 64,995, (Nov. 26, 2019)
- More time to make "use it or lose it" gifting decisions
- But there are risks to further delaying gifts:
  - Asset appreciation between now and the date of the gift (future gift of appreciated asset uses more exemption than a gift now)
  - Congress could act sooner to reduce exemptions or prohibit common gifting strategies (Grantor Trusts, discount rules)

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Case Study – Ms. Doe

- Ms. Doe has a $21 million estate, has used 700k of her exemption, and makes a further $11 million gift to reduce her estate to $10 million
- If Ms. Doe dies in 2026, she would have $0 remaining exemption and her estate would owe $4 million in estate tax (40% of $10 million)
  - $10 million estate
  - Less: $ 0 rem. exmptn. ($11.7m prior gifts fully utilized $6m exemption)
  - $10 million
  - x 40%
  - $4 million of estate tax

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Case Study – Ms. Doe (cont.)

- BUT if Ms. Doe made no further gift and dies in 2026, she would have $5.3 million in remaining exemption (est. $6 million exemption, less 700k of prior gifts)
- Ms. Does estate would owe $6.28 million in estate tax:
  - $21 million estate
  - Less: $5.3 million rem. exemption
  - $15.7 million
  - x 40%
  - $6.28 million of estate tax
- Ms. Doe's estate would have saved $2.28 million in estate tax if she had used her increased exemption amount

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Gifts Must Be Substantial

- Ms. Doe makes a gift of $2 million in 2021 (when the exemption amount is $11.7 million) but later passes away in 2026 when the exemption is $6 million. So, Ms. Doe's applicable exclusion amount is $4 million (the prior gift reduces exemption).
  - $21 million estate
  - Less: $4 million rem. exemption
  - $17 million
  - x 40%
  - $6.8 million of estate tax
- Important: To take full advantage of tax savings, gifts must exceed what the exemption will be reduced to

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Gifts Must Be Substantial (cont.)

- **“Wait… You are saying that I need to give away *more than* $6 million to take full advantage of this strategy?”**
  - **Yes.**
  - **However, gifting less than the anticipated exemption at least keeps the gifted asset’s post-date of gift appreciation from further using up exemption**

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Gifting Techniques Before Sunset

- Gift to an Intentionally Defective Grantor Trust (IDGT)
  - Gift of assets that have a strong potential to appreciate and take advantage of the current estate tax exemption
  - Future growth of assets transferred will be removed out of the grantor’s gross estate
  - Donor pays the income tax associated with the trust assets, further reducing size of grantor’s estate while not being considered a gift to the trust or the trust beneficiaries

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Sale to an Intentionally Defective Grantor Trust (IDGT)

- Grantor makes a seed gift of cash to a trust, which uses the cash plus an installment note to purchase appreciated or appreciating assets from the Grantor. The trust is structured so that the assets of the trust are excluded from the Grantor's estate for Federal estate tax purposes.
  - Not a taxable sale
  - Freezes value
  - Lower rate
  - Donor pays income tax

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Spousal Lifetime Access Trust (SLAT)

- Similar provisions to a classic IDGT, but spouse is added as a beneficiary
  - Provides a means for parents to retain cashflow from gifted assets
  - Risk of inclusion and risk of donee spouse predeceasing donor spouse
  - Reciprocal trust doctrine

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Gifting Techniques Before Sunset

- Consider Wait and See Disclaimer Trust
  - Provides flexibility to decide whether to make the gift or not
  - Transfer to irrevocable trust with a short-term marital trust for spouse; if no disclaimer then hand the gift back; if disclaims then it's held in trust for spouse and/or issue
  - Risk of inclusion and risk of donee spouse predeceasing donor spouse
  - Gift tax return required even if hand back to spouse

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Gifting Techniques Before Sunset

- **Additional considerations:**
  - **GRATs, QPRTs, ILITs, FLPs, LLCs**
  - **Beware: Step Transaction Doctrine**
    - **When transfers and gifts occur within a short window of time, the transfer and gift can be collapsed into one transaction. It is safest to wait at least 45 days between transfer and gift.**
  - **How to make a gift in 2021 without going over the exemption amount, when we are uncertain about value and don't have final appraisals?**
    - **Defined Value / Formula Gifts**
    - **Wandry v. Commissioner; Nelson v. Commissioner**
    - ***"as finally determined for federal estate and gift tax purposes"***

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Inherited IRA Landmines

- **Evolving Retirement Landscape**
  - **Increased longevity**
    - A 65-year-old can expect to live well into their 80s
    - Senior population expected to double over 30 years
  - **Retirement income sources have evolved**
    - Responsibility to save for retirement has been shifted to the employee
    - Increases in delayed retirement
  - **Trillions of dollars in IRAs and Qualified Plans**
    - Taxes must be considered when taking distributions
    - Consider: early withdrawal penalties, RMDs, distribution timing, etc.
  - **Required Minimum Distributions:**
    - **For the Participant: 72 (if you turn 72 before December 31, 2021, you must take your 1st RMD by April 1st, 2022**
    - **For beneficiaries of inherited IRAs/retirement accounts, a different set of rules apply**

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Inherited IRA Landmines

- **Year of Death RMDs**
  - **The RMD for the year of death will only need to be taken if the IRA owner died on or after their Required Beginning Date**
  - **Must be taken by December 31st – decedent's RMD rules apply to year of death RMD calculation (not the beneficiary's RMD calculation)**
  - **If not taken by the decedent before death, it must be taken by the <u>beneficiary</u> (Rev. Ruling 2005-36)**
  - **Failure to take Year of Death RMD? *<u>50% Penalty</u>* on what wasn't taken**

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Inherited Retirement Accounts & IRAs

- SECURE Act of December 2019
  - **The "stretch IRA" is no longer available for most beneficiaries**
  - **Now, most beneficiaries have to take distributions over a 10-year period – BUT, there is no requirement to withdraw distributions annually**
    - **Exceptions to the 10- Year Rule:**
      - **Participant's surviving spouse**
      - **Participant's minor child**
      - **Disabled of chronically ill beneficiary**
      - **Beneficiary less than 10-years-younger than the Participant**
      - **Non-designated beneficiary? 5-year (not 10-year) period applies**
        - **Estates, certain trusts**

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Case Study: No beneficiary listed

- Joe named his wife Mary as beneficiary of his IRA in 2005.
- He was in a hurry and told his benefits coordinator that he would get back to her about a contingent beneficiary.
- And, of course, he never did.
- Mary died unexpectedly, and Joe was too distraught to engage in sound financial planning.
- Joe dies with $500K left in his IRA. What happens?
  - No beneficiary listed, then the default rule is that the estate is the beneficiary
  - The entire account must be liquidated by the end of the 5th year following Joe's death.
- Is that the end of the story?
  - Perhaps – IRAs are governed by contract, and some agreements may provide for a beneficiary if blank (e.g., spouse, issue, per stirpes, etc.)
  - Coordinate with IRA custodian to have separate shares established so each beneficiary can pull out their portion over 5 years however he or she wants

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Case Study: Surviving Spouse

- Maude (55) dies in 2021 with a $3 million IRA.
- Maude designated Harold (53) as sole beneficiary of the IRA.
- The Tax Code provides favorable treatment for IRA benefits payable directly to the surviving spouse.
- Harold's options:
  - (1) Lump sum distribution
  - (2) Spousal rollover
  - (3) Treat as an inherited IRA and use the life expectancy payout, with annual distributions beginning in the year the decedent would have reached 72
    - Why not rollover? Pre-59 ½ distributions from an inherited IRA aren't subject to Section 72(t) 10% penalty
  - There is no deadline for a spousal rollover to occur
    - Could start with option (3) and switch to option (2) several years later (for example, after Harold reaches age 59 ½)

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Case Study: Surviving Spouse (Children from a prior relationship)

- Dennis has a $2 million IRA and is married to Delores (Dennis's 3rd marriage). Dennis and Delores each have children from prior marriages.
- Dennis wants to provide for Delores but wants his kids to benefit after Delores passes away.
- Options:
  - (1) Designate Delores as direct beneficiary (see options in prior slide)
    - **Problem: What if Delores names her children from a prior marriage? Or her new husband?**
  - (2) Name a Conduit Trust for Delores's benefit
    - **Delores must be the sole trust beneficiary**
    - **Same options as if Delores were named as beneficiary, except no rollover**
    - **Trustee is required to pass out to Delores all distributions the trust receives from the inherited IRA**
    - **If Delores lives to her life expectancy, almost all benefits will have been paid out to her**
  - (3) Name a non-conduit trust, QTIP Trust?
    - **10-Year Rule Applies (as long as the Trust is a see-through trust)**
    - **All benefits will be paid and taxed to the trust at trust rates, except to the extent distributions are passed out to Delores**

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Case Study: Minor beneficiaries

Jerry and Elaine are married, in their 30s, and have four minor kids. If they both pass away, they are concerned about how to designate their IRA/401(k) assets.

- **Avoid naming minor as direct beneficiary**
- **Conduit trust?**
  - **Trustee is required to distribute IRA distributions to (or for the benefit of) the child/children**
  - **10-Year-Rule won't kick in until age 18**
- **Name a non-conduit trust?**
  - **All benefits will be paid and taxed to the trust at trust rates**

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Case Study: Beneficiaries with a history of being financially irresponsible

- Taylor (75) has three adult children. Taylor wants to leave her $3 million IRA to her children but does not want them to be able to take a lump sum distribution, is concerned mandating distributions over a 10-year period given spendthrift concerns and is concerned about trust income tax rates. Taylor is also charitably inclined.
- **Consider:**
  - **Leave IRA to a Charitable Remainder Trust?**
    - **CRT pays no tax on the lump sum payout of the IRA**
    - **CRT can provide for a unitrust stream of income to be paid out during the joint lifetimes of her children**
    - **On the death of the surviving child, all remaining CRT funds pass to charities selected by Taylor**
    - **Produces a charitable deduction to Taylor's estate**

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