Post-Election Estate Planning; Year-End Reminders

November 29, 2016

The results of this month's Presidential and Congressional elections have significantly changed expectations regarding the federal estate, gift and generation-skipping transfer (GST) taxes. During the lead-up to the election, there were concerns about possible rate increases and reduced exemption amounts and certain proposed regulations applicable to the transfer tax valuation of interests in family-controlled businesses and investment vehicles. Post-election, those regulatory concerns no longer seem pressing, and there are expectations of tax reform legislation that may include provisions repealing the gift tax, as well as the estate and GST taxes, with possible related modifications to current federal income tax rules which provide for the income tax basis of a decedent's assets to be reset to estate tax values (sometimes referred to as a "step-up" in basis) and the non-recognition of gain on appreciated property transferred at death or by lifetime gift.

Moreover, while the issuance of detailed tax reform legislation is reported to be on the House Republicans' agenda for the first 100 days of the Trump administration, the specific terms of any provisions relating to the repeal of the federal estate, gift and GST taxes, and the extent to which those provisions might constitute an opening bid to help achieve more limited or other tax objectives, remain uncertain.

In this context, included below are:

- A reminder about certain gifting programs and structures that do not involve the payment of any, or only very limited, gift tax and therefore continue to be attractive during this period of transfer tax uncertainty.
- A reminder regarding the current New York, New Jersey and Connecticut transfer tax rules, some of which are already scheduled to change in 2017 and beyond.
- A reminder about "formula clauses" that may provide for dispositions to family members based on federal or state transfer tax exemption amounts, and why you might want to revisit your estate planning documents if they have such clauses or otherwise include dispositions premised on the existence of a significant federal estate tax (such as a bequest to a family foundation intended as an alternative inheritance for family members who control the foundation).
- A comparison of certain aspects of the current federal estate, gift and GST tax regimes with certain alternative, or modified, income tax rules proposed by then-candidate Trump, the House Republicans and President Obama in his 2017 "Greenbook" proposal.[1]

In addition, while an estate plan should be appropriately tax influenced, it should also address other non-tax family concerns, goals and objectives. In this regard, we generally urge our clients to review their estate plans at least every five years, and more frequently in the event of significant personal, family or financial developments and changes in the tax laws.

[1] The 2017 Greenbook proposal was a modified income tax realization at transfer regime that would have applied in addition to the current estate, gift and GST tax regimes (and with related credits to avoid double transfer and income taxation of the same unrealized appreciation), but can also be viewed as a fallback Democratic negotiating position as to the contours of any income tax regime that might accompany the repeal of the federal estate, gift and GST taxes.

Certain Gifting Programs and Structures

During this period of transfer tax uncertainty, we would generally expect clients to avoid gifting programs and structures that result in the prepayment of federal estate tax (sometimes at effectively lower rates) by reason of the payment of gift tax.

Nevertheless, significant gifts to children or more remote descendants within the currently available exemption amounts may continue to be advisable as part of an overall estate plan and, when advisable, there will continue to be potential tax and non-tax benefits for those transfers to be made in trust.

The following gifting programs and structures, some of which may be particularly attractive in anticipation of future increases in interest rates, do not involve the payment of gift tax.

Annual Exclusion Gifts

As a reminder, when consistent with other family goals and financial considerations, it is a best practice to make use of the federal gift tax annual exclusion amount available for gifts of "present interests" to or in respect of a particular donee.[2]

For 2016, a donor generally may exclude from taxable gifts the first $14,000 of qualifying gifts to or in respect of a particular donee.[3] For gifts by a U.S. citizen or domiciliary to his or her non-U.S. citizen spouse, the available annual exclusion amount is $148,000.[4] The basic annual exclusion amount will remain at $14,000 for 2017, with the exclusion for gifts to a non-U.S. citizen spouse increasing to $149,000.

Direct Payment of Tuition and Certain Medical Expenses

For 2016 and 2017, direct payments to the relevant service provider of certain qualified tuition and medical expenses on behalf of the individual receiving the related goods and services will continue to be exempt from gift tax.

Topping Up Existing Trusts with Increased Exemption Amounts

Individuals who exhausted their gift tax exemption by the end of 2015 (when the relevant exemption amount was $5,430,000) can give another $20,000 ($40,000 for married couples able to split the relevant gifts) through the end of 2016 without incurring gift or GST tax.

For 2017, these exemption amounts will increase by another $40,000 ($80,000 for married couples able to split the relevant gifts).

Individuals who have not yet made 2016 top-up gifts may wish to consider making those gifts in January 2017 together with any 2017 top-up gifts (in which case they might be able to avoid filing a 2016 gift tax return and instead file only a 2017 gift tax return).

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[2] The types of gifts that qualify for treatment as gifts of present interests (and whose aggregate value counts towards the applicable limitation in respect of a particular donee) include outright gifts of cash or marketable securities to, and similar contributions to a 529 account, custodial account or minority trust for, a particular donee or to a "Crummey" trust which provides the particular donee with a power to withdraw property that lapses over time.

[3] Spouses may elect to split gifts and claim a combined exclusion of $28,000 with respect to a particular donee, even if one spouse funds more than half of that combined exclusion in respect of the same donee.

[4] There is a larger annual exclusion for such gifts because, unlike gifts to a U.S. citizen spouse, gifts to a non-U.S. citizen spouse that exceed the annual exclusion cannot qualify for the unlimited gift tax marital deduction.

Interest Rate Related Strategies

- ***Intra-Family Loans***. An intra-family loan is a simple technique for transferring wealth to children or grandchildren without generating gift or GST tax. To avoid making a gift, the lender must charge interest at the applicable federal rate (AFR) published by the IRS. These loans are particularly effective when AFRs are low.
  - For December 2016, the AFRs (based on annual compounding) used in connection with intra-family loans are 0.74% for loans with a term of three years or less, 1.47% for loans with a term of up to nine years and 2.26% for loans with a term longer than nine years.
  - For example, if a nine-year loan is made to a child in December 2016 and that child can invest the funds and obtain a return in excess of 1.47%, the excess will effectively be transferred to the child free of gift tax. The lender must include the interest payments on the note in the lender's taxable income.
  - Making a loan to a so-called "grantor trust" for the benefit of a child where the grantor continues to be subject to tax on the trust's taxable income, including capital gains, may be even more tax efficient than making a loan to the child outright. Since transactions between the grantor and the grantor trust are generally disregarded for income tax purposes, the grantor/lender will not have to include the interest payments on the note in the lender's taxable income and the trust beneficiaries can also benefit from the grantor's payment of income taxes on the trust's investments.
  - Grantors can also sell assets to a grantor trust in exchange for a note without incurring any current income tax liability; such assets may include interests in family businesses and investment vehicles that currently may be valued giving effect to certain valuation discounts.
- ***GRATs***. A GRAT (grantor retained annuity trust) may currently be structured to result in a taxable gift of zero (or close to zero). GRATs are particularly attractive in the current low interest rate environment.
  - In creating a GRAT, the grantor transfers assets to a trust while retaining the right to receive an annuity for a term of years specified by the grantor.
  - The amount of each year's annuity payment (which under the applicable rules can increase by up to 20% each year) required to reduce the taxable gift to zero (or close to zero) is calculated based on the term of the GRAT, the percentage, if any, by which each year's annuity payment differs from the prior annuity payment, and an interest rate published by the IRS (the "7520 rate").
  - If the trust's assets appreciate at a rate greater than the 7520 rate (1.8% for transfers made in December 2016), at the end of the GRAT term the excess appreciation will be distributed to the remainder beneficiaries (e.g., children or a trust for children) free of gift tax.
  - While a common strategy has been to fund a series of short-term GRATs with volatile assets in the hope of, at some point, locking in a gain in excess of the 7520 rate, grantors are also creating longer-term GRATs in the current rate environment, both in anticipation of future rate increases and because of risks of legislative changes to the applicable rules (which could conceivably be modified for revenue offset purposes as part of a tax reform package that may or may not ultimately include a repeal of the gift tax).
  - The assets transferred to a GRAT may include interests in family businesses and investment vehicles that currently may be valued at a discount, including for purposes of determining the amount of the required annuity payments.

- ***CLATs***. For the charitably inclined, a CLAT (charitable lead annuity trust) is another technique that works well in a low interest rate environment and is similar to a GRAT, except that each year's annuity payment is made to charity instead of to the grantor.
  - Like a GRAT, a CLAT can be structured to generate little to no gift tax.
  - A CLAT can also be structured to result in a current income tax deduction for the grantor equal to the actuarial value of the future annuity payments to be made to charity, but this treatment also requires the grantor to be subject to income tax on the trust's ongoing ordinary income and capital gains (which may be less of a burden if future tax rates are anticipated to be reduced).
  - In the alternative, a CLAT can be structured so it is respected as a separate taxpayer and is entitled to its own income tax charitable deduction in respect of amounts distributed to charity during the relevant tax year, in which case the grantor is not entitled to any income tax charitable deduction in connection with the initial funding of the trust (and is not subject to tax on the trust's ordinary income and capital gains).

Certain State Transfer Tax Rules

New York

The New York estate tax exemption equivalent is currently limited to a maximum of $4,187,000 and is scheduled to increase to $5,250,000 on April 1, 2017 and to eventually match the federal estate tax exemption equivalent on January 1, 2019. However, the applicable New York estate tax exemption equivalent is phased out for New York taxable estates valued between 100% and 105% of the exemption amount, with ultimately no exemption being available for taxable estates in excess of 105% of the exemption amount. The top New York estate tax rate is 16% (although the effective rate may be less due to the deduction for federal estate tax purposes of estate tax paid to New York). There is no New York gift or GST tax, but special estate tax rules apply to gifts of property made within three years of death.

New Jersey

The New Jersey estate tax is intended to be repealed effective January 1, 2018. This change was part of a bill signed into law by New Jersey Governor Chris Christie on October 14, 2016, which also raised the gas tax by 23 cents per gallon and lowered the sales tax.

Currently, New Jersey decedents dying in 2016 with estates exceeding $675,000 are subject to New Jersey estate tax, with a top rate of 16%. In 2017, the New Jersey estate tax will apply only to estates exceeding $2 million. Beginning January 1, 2018, New Jersey is expected no longer to impose an estate tax, although technical corrections may be required to relevant statutory provisions.

New Jersey will, however, retain its separate inheritance tax, which does not generally apply to transfers to a spouse, child or grandchild. The New Jersey inheritance tax is based on the relationship between the decedent and the beneficiary receiving assets from the decedent. Under the inheritance tax, transfers to siblings are generally taxed at a rate beginning at 11% (top rate is 16%) and transfers to others are taxed at a rate of 15% or 16% (New Jersey inheritance tax is also deductible for federal estate tax purposes).

Connecticut

Connecticut is the only state that imposes a gift tax. The Connecticut estate and gift tax exemption amount is currently $2 million, with a $14,000 gift tax annual exclusion. Connecticut estate and gift tax rates range from 7.2% (for estates and gifts exceeding $2 million) to 12% (for estates and gifts exceeding $10.1 million). The estate tax is capped at $20 million. Estate tax paid to Connecticut may be deducted for federal estate tax purposes, but there is no corresponding federal gift tax deduction.

Formula and Other Tax Influenced Dispositions

Some testamentary plans may include so-called "formula dispositions" in an amount equal to a particular federal or state tax exemption, or other tax influenced dispositions, that could have unintended consequences in the event of the repeal or modification of the related tax.

For example, in the past it was not uncommon for a decedent's Will to include a "credit shelter disposition" to a trust that included children as beneficiaries, with the balance of the estate passing to or in trust for a surviving spouse. Credit shelter dispositions were often defined by a formula expressed in terms of the maximum amount that could pass at death from the decedent's estate free of federal estate tax. In these circumstances, if there were no federal estate tax in effect at death, it is possible that the recipients of a credit shelter bequest might argue that the decedent's entire estate should be disposed of pursuant to the formula bequest, leaving nothing for the surviving spouse. Conversely, if the federal GST tax and related GST exemption are repealed, formula bequests tied to the amount of a decedent's unused GST exemption might result in no bequest to grandchildren when one may have been intended.

Similarly, in the event of the repeal of the federal estate tax, individuals who have included dispositions to family donor-advised funds and private foundations as a transfer-tax-efficient, alternative inheritance for their descendants might, depending on the related income tax rules that accompany any repeal, consider leaving those funds directly to their descendants. A descendant could use the inherited funds for his or her own charitable giving (including to fund a donor-advised fund or private foundation) and also enjoy any available income tax charitable contribution deduction.

Accordingly, we would suggest you review your estate planning instruments to determine whether they contain any formula clauses or other dispositions that could have unintended consequences in the event of a repeal of the federal estate or GST tax, or other state-level changes in any relevant tax rules.

Comparison of Current Rules with Possible Repeal Proposals

Set forth below is a general comparison of the current federal estate, gift and GST tax regimes, and related income tax rules, with alternatives proposed by then-candidate Trump, the House Republicans[5] and President Obama in his 2017 "Greenbook" proposal.[6]

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[5] House Republicans issued a tax reform blueprint on June 24, 2016.

[6] The separate proposals made by then-candidate Trump and the House Republicans do not specifically address the federal gift tax. As an alternative to repeal, the gift tax could be retained in its current form, perhaps with some modified exemption amount and other currently applicable exclusions, in lieu of any new income tax gain realization regime along the lines set forth in the 2017 Greenbook proposal. The 2017 Greenbook proposal was issued by the Obama administration in the normal course of the federal budget process and included a proposal to treat a gift or bequest of appreciated property as a transfer that was both subject to gift or estate tax, and an immediate income tax realization event. This proposal might be viewed as a Democratic fallback negotiating position in the context of any proposal to repeal the gift and estate tax, or as a way to further offset some of the budgetary costs of repealing those taxes.

	Current Rules – Estate, Gift & GST Tax/ "Step-Up In Basis" at Death Without Gain Recognition/ Carry Over Income Tax Basis for Lifetime Gifts	Possible Repeal – No Estate, Gift & GST Tax/ No or Limited "Step-Up In Basis" at Death/ Possible Gain Recognition for Gifts and Bequests of Appreciated Property
Estate, Gift and GST Tax Exemption Equivalents	$5.45 million ($5 million indexed for inflation, increasing to $5.49 million for 2017)	None (if no estate, gift or GST tax)
Highest Marginal Estate, Gift and GST Tax Rate	40%	None (if no estate, gift or GST tax)
Per Donee Gift Tax Annual Exclusion	$14,000 ($10,000 indexed for inflation, no increase for 2017)	None (if no gift tax)
Gift Tax Exclusion for Direct Payment of Qualified Tuition and Medical Expenses	Yes	None (if no gift tax)
Spousal Portability at Death of Deceased Spouse's Unused:		
Estate/Gift Tax Exemption	Yes	None (if no estate or gift tax)
GST Tax Exemption	No	None (if no GST tax)
Gift and Estate Tax Marital and Charitable Deductions	Yes	None (if no estate or gift tax)
Federal Estate Tax Deduction for State-Level Estate Taxes Paid	Yes	None (if no estate tax)
Valuation Discounts, "Zeroed Out" GRATs, "Perpetual" GST Tax Exempt Trusts and Income Tax "Grantor Trusts" Permitted	Yes	May still be permitted, but may not be relevant
"Step-Up" in Income Tax Basis for Property Passing at Death (without incurring any capital gains tax)	Unlimited[7] Including situations in which no estate tax is payable by reason of exemption amounts and the application of the federal estate tax marital deduction	Possibly None or Limited ▪ **House Plan**: Possibly None ▪ **Trump Plan**: Step-up in basis for up to $10 million (to exempt small businesses and family farms) ▪ **Obama "Greenbook" Plan**: Limited[8]

[7] Except for items of "income in respect of a decedent" (e.g., inherited traditional IRA).

[8] Under the 2017 Greenbook proposal, the deceased owner of an appreciated asset would realize a capital gain at the time the asset is bequeathed to another; the amount of the gain realized would be the excess of the asset's fair market value on the date of the transfer over the donor's basis in that asset. The unlimited use of capital losses and carry forwards would be allowed against (*cont.*)

	Current Rules – Estate, Gift & GST Tax/ "Step-Up In Basis" at Death Without Gain Recognition/ Carry Over Income Tax Basis for Lifetime Gifts	Possible Repeal – No Estate, Gift & GST Tax/ No or Limited "Step-Up In Basis" at Death/ Possible Gain Recognition for Gifts and Bequests of Appreciated Property
Dying Owning an Appreciated Asset Results in Capital Gain Subject to Income Tax	No	Maybe ▪ **House Plan**: Not addressed ▪ **Trump Plan**: Not addressed except for step-up in basis for up to $10 million (to exempt small businesses and family farms) ▪ **Obama "Greenbook" Plan**: Yes[9]
Decedent's Estate May Claim Income Tax Charitable Deduction for Unrealized Appreciation Passing to Charity	No	Maybe ▪ **House Plan**: Not addressed ▪ **Trump Plan**: No income tax deduction for contributions of appreciated assets into a private charity established by the decedent or the decedent's relatives ▪ **Obama "Greenbook" Plan**: No
Gift of Appreciated Property Results in Realization of Capital Gain Subject to Income Tax	Generally, No	Maybe ▪ **House Plan**: Not addressed ▪ **Trump Plan**: Not addressed ▪ **Obama "Greenbook" Plan**: Yes[10]

(*cont.*)

ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate. Bequests to a spouse or to charity would carry the basis of the decedent and capital gains would not be realized until the spouse disposes of the asset or dies. Gains on tangible personal property would be exempt, and there would be a $100,000 per person exclusion of other capital gains recognized by reason of death that would be indexed for inflation after 2017, and would be portable to the decedent's surviving spouse (making the exclusion effectively $200,000 per couple). A $250,000 per person exclusion for capital gain would apply to all residences, and also would be portable to the decedent's surviving spouse (making the exclusion effectively $500,000 per couple).

[9] Id.

[10] Under the 2017 Greenbook proposal, the donor of an appreciated asset would realize a capital gain at the time the asset is given to another. The amount of the gain realized would be the excess of the asset's fair market value on the date of the transfer over the donor's basis in that asset. The gain would be taxable income to the donor in the year the transfer was made. Gifts to a spouse or to charity would carry the basis of the donor and capital gains would not be realized until the spouse disposed of the asset or dies. Gains on tangible personal property would be exempt.

If you have any questions regarding this update, would like to explore any of the matters mentioned above or want a detailed review of your current estate plan, please contact any of the lawyers listed below or your regular Davis Polk contact.

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