

Estate Planning Election Eve Highlights

October 30, 2020

For much of 2020, estate planning clients have been focused on continuing to take advantage of the historically high federal estate, gift and generation-skipping transfer (“GST”) tax exemption amounts, which are currently \$11.58 million per individual (\$23.16 million combined for a married couple). The increased exemption amounts are currently scheduled to expire at the end of 2025, when they would revert to the 2017 level of \$5 million, plus relevant inflation adjustment amounts. As a reminder, using gift tax exemption to make lifetime gifts free of gift tax reduces the estate tax exemption available at death, but removes both the gifted amount and any appreciation thereon from the donor’s taxable estate. The current tax rules are clear that gifts made using the current increased gift exemption amounts will not subsequently result in increased estate taxes if a taxpayer dies in a later year when the exemption amounts are lower than current levels. The rules are also clear that current allocations of GST exemption to such gifts (e.g., so that property transferred in trust for children may eventually benefit grandchildren without being subject to additional transfer tax) will also be effective, even if the GST exemption amount is subsequently reduced.

With interest rates at or near all-time lows, other estate planning strategies mentioned in our March 2020 Client Memorandum (available [here](#)), including GRATs, intra-family loans and installment sales to grantor trusts, continue to be attractive.

Potential Changes to the Estate Planning Landscape

Absent legislative action to change the exemption amounts (as noted below), the 2021 inflation-adjusted federal estate, gift and GST tax exemption amounts will be \$11.7 million per individual (up from \$11.58 million in 2020), or a combined \$23.4 million for a married couple. Clients who have exhausted their exemptions in 2020 may wish to consider using this \$120,000 (\$240,000 for a married couple) inflation adjustment to “top up” existing trusts early in 2021 (after factoring in election results and any related risks of retroactive tax legislation).

If Vice President Biden wins the presidential election and the Democrats take control of the Senate (while also retaining control of the House), new legislation increasing transfer tax rates and lowering the federal estate, gift and GST tax exemption amounts could be enacted at some point next year, with possible retroactive effect to January 1, 2021.¹ In addition, Vice President Biden has called for the elimination of the “step up” in tax basis for assets held at death and, in his unity pledge with Sen. Sanders, has advocated for returning the estate tax to its “historical norm”. More generally, proposals by Democrats in recent years have included the significant curtailment of grantor retained annuity trusts (so-called “GRATs”) and eliminating the use of valuation discounts for gifting.

While we cannot forecast the substance or timing of any such potential legislative changes, set forth on the last page of this Memorandum is a general comparison of certain federal transfer and related income tax rules: (i) currently in effect, (ii) scheduled to become effective on January 1, 2026 but which could potentially be accelerated through the enactment of new tax legislation, and (iii) proposed by the Obama

¹ While retroactive tax legislation is subject to due process considerations, historically, retroactivity to January 1 of the year in which legislation is enacted has generally been deemed constitutional (at least in the case of tax rates). Retroactivity going back further in time would be subject to greater scrutiny.

administration in its 2017 Greenbook.² The 2017 Greenbook could be viewed as an additional reference point for possible reductions in exemption amounts and increases in transfer tax rates under a Biden administration.

Year-End Gifting

Depending on an individual's personal family and financial situation, it may be particularly compelling to consider making significant lifetime gifts before the end of this year, in order to take advantage of the increased exemption amounts while they are still available.

The optimal year-end recipient of a gift may vary depending on the donor's objectives. For example:

- Many clients have chosen to make lifetime gifts to long-term, GST tax-exempt trusts for the benefit of descendants. Clients who already have such trusts in place are encouraged to review their trust documents to make sure they are consistent with current wishes and, if not, to consider creating new trusts to use their remaining gift and GST tax exemptions.
- Clients concerned that additional lifetime giving may put their financial security at risk might consider creating a "SLAT" (spousal lifetime access trust), which includes their spouse as a trust beneficiary, or exploring the creation, in certain circumstances, of a "self-settled asset protection trust" in a jurisdiction that permits such a trust.

Clients considering 2020 gifts should act sooner rather than later. In particular, clients who wish to make gifts of real estate or non-marketable financial assets should act promptly to ensure that a preliminary appraisal can be obtained in a timely fashion and that the transaction can be completed before year end. For gifts of financial assets, opening new trust accounts at year end may be difficult, if not impossible, if large numbers of individuals are trying to implement similar year-end planning.

Other Considerations for Using Exemptions

It may be advisable for married couples who are planning to make additional gifts this year that, in the aggregate, will not exceed one spouse's remaining exemption to structure and fund such gifts so they are all made by the same donor spouse (and not elect to split gifts on their 2020 gift tax returns) so that only the donor spouse's gift tax exemption is used. If the federal gift or estate tax exemption is subsequently reduced, all or a portion of the non-donor spouse's (reduced but unused) exemption will remain available for future use.

Other planning opportunities, in addition to those mentioned in our March 2020 Client Memorandum, which may be attractive to clients before year end include the following:

- Clients who are not interested in making additional gifts or have exhausted their gift tax exemptions, but who already have in place funded trusts for the benefit of children that may ultimately pass to grandchildren and are not already exempt from GST tax, may wish to allocate their remaining GST tax exemptions to those trusts.
- Clients with life insurance trusts who anticipate that future gifts for premium payments may result in gift and/or GST tax might wish to pre-fund such trusts this year.
- With respect to trusts that will soon be terminating by their own terms, it might be advantageous to make distributions to trust beneficiaries who would not otherwise have the resources to take

² The 2017 Greenbook was issued by the Obama administration in the normal course of the federal budget process and included proposals regarding tax legislation going into 2017.

advantage of the current increased exemption amounts in order to facilitate gifting by such beneficiaries.

- Clients who have exhausted their gift tax exemptions, have no other current use for remaining GST exemptions and are focused on ultimately funding trusts to benefit multiple generations may wish to consider creating lifetime “QTIP” trusts for the benefit of their spouse and allocating GST exemption to these trusts. While this strategy would not result in any reduction in future estate tax liability when the property passes in further trust for descendants, it would create a larger pool of assets to eventually benefit grandchildren free of GST tax.
- Given the possibility of changes to the current rules regarding so-called “zeroed-out GRATs”, clients might consider creating one or more longer-term GRATs.

Special considerations may also apply to Connecticut and New York residents due to state level transfer taxes. Connecticut is the only state that has a gift tax, which applies to gifts by Connecticut residents other than gifts of real or tangible personal property located outside Connecticut. In New York, although there is no state level gift tax, gifts made within three years of death may result in the imposition of New York estate tax even if the estate otherwise qualifies for the unlimited marital or charitable deduction.

Finally, if year-end gifting is not an available option and clients are concerned about the possibility of the enactment of tax legislation next year with a retroactive effective date (e.g., that they anticipate being able to make a gift in January 2021 but are concerned that legislation reducing exemption amounts might be enacted with an effective date of January 1st and thereby cause them to incur gift tax), those clients might consider making gifts to a trust for the benefit of their spouse that is eligible to be a so-called “QTIP” trust. If properly structured, the client would have until October 15, 2021 to file a gift tax return on which to elect to take the unlimited gift tax marital deduction in respect of that gift. If they were comfortable that by that date there was not going to be any retroactive tax legislation, they would not make the election and instead use their unreduced gift (and potentially GST) tax exemption so that the trust property as constituted on the spouse’s death could pass to children (and potentially grandchildren) free of transfer tax. If retroactive tax legislation was enacted or still of concern, they would elect to take the unlimited gift tax marital deduction, in which case the trust property might be fully distributed to the spouse beneficiary. Other “disclaimer-based strategies” may also afford additional time (up to nine months after a gift) to “undo” the gift.

See next page for Comparison Chart

Comparison of Certain Transfer Tax and Related Income Tax Rules

	<u>Current Law</u> (currently in effect, with a scheduled 1/1/2026 return to 2017 rules)	<u>2017/2026 Rules</u> (a return to these rules could be accelerated through new legislation and considered a partial return to "historical norms")	<u>Obama Administration 2017 Greenbook</u> (additional reference point for possible "historical norms" and Biden comments on eliminating "step-up" in basis)
Estate, Gift and Generation Skipping Transfer (GST) Tax Exemption Equivalents	\$11.58 million (\$10 million indexed for inflation, increasing to \$11.7 million for 2021)	\$5 million indexed for inflation (2011 rules)	\$3.5 million estate and GST tax exemptions, \$1 million gift tax exemption (2009 rules)
Highest Marginal Estate, Gift and GST Tax Rate	40%	Same as Current Law	45% (2009 rules)
"Step-Up" in Income Tax Basis for Property Passing at Death (without incurring any Capital Gains Tax)	Unlimited ³ Including situations in which no estate tax is payable by reason of exemption amounts and the application of the federal estate tax marital deduction	Same as Current Law	Limited ⁴
Gift of Appreciated Property Results in Realization of Capital Gain Subject to Income Tax	Generally, No	Same as Current Law	Yes ⁵
"Zeroed-Out" GRATs, "Perpetual" GST Tax Exempt Trusts and Income Tax "Grantor Trusts" Permitted	Yes	Same as Current Law	No

³ Except for items of "income in respect of a decedent" (e.g., inherited traditional IRA).

⁴ Under the 2017 Greenbook, 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 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, 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 gains would apply to all residences, and also would be portable to the decedent's surviving spouse (making the exclusion effectively \$500,000 per couple).

⁵ Under the 2017 Greenbook, 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 charity would carry the basis of the donor and capital gains would not be realized until the spouse disposed of the asset or dies. Gain on tangible personal property would be exempt.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

Paula A. Ryan	212 450 4611	paula.ryan@davispolk.com
Jeffrey N. Schwartz	212 450 4957	jeffrey.schwartz@davispolk.com
Sarah L. DeBergalis	212 450 4573	sarah.debergalis@davispolk.com
Kelly V. Dunn	212 450 4860	kelly.dunn@davispolk.com
Brian G. Sieben	212 450 4594	brian.sieben@davispolk.com
Lucy M. Taylor	212 450 3112	lucy.taylor@davispolk.com
Rachel Weissmann	212 450 4774	rachel.weissmann@davispolk.com

© 2020 Davis Polk & Wardwell LLP | 450 Lexington Avenue | New York, NY 10017

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's [privacy notice](#) for further details.