2020 In Review

Highlights & Perspectives

GLOBAL PANDEMIC, LEGISLATIVE ACTION, AND CHANGES ON THE HORIZONt

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Key Points

- The global coronavirus pandemic and resulting economic slowdown, as well as the effects of tax legislation over the last three years, have resulted in what many commentators call an "Estate Planning Trifecta."
- Major tax legislation may be on the horizon if Democrats gain control of Congress and the White House.
- Clients should understand the recent changes, as well potential tax law changes, and how they may affect their planning
- Some current strategies may help to leverage the existing environment

This year, we suffered a global pandemic caused by the Covid-19 virus, endured a world-wide economic slowdown, and witnessed a historic election here in the United States. From an estate planning perspective, we briefly examine the landscape, survey potential tax law changes, and sample some strategies to leverage the current conditions.

A combination of legislative action over the last three years and the economic effects of the coronavirus pandemic have caused what some in the estate planning community are calling a "trifecta," that is, a set of three conditions that planners can leverage for tax-free wealth transfer: (1) historically high transfer tax exemptions (allowing clients to pass more wealth tax-free), (2) low interest rates prescribed by the IRS (which benefit several wealth transfer strategies), and (3) low asset values (which allows for gifting of assets that may increase in value after gifting, thus side-stepping transfer taxes for the difference between current and future value).

Estate Planning "Trifecta"

- High Estate and Gift Tax Exclusions
- Low Interest Rates
- Low Asset Values

LEGISLATIVE LANDSCAPE

The estate planning landscape has been shaped by three major legislative acts over the last three years.

Legislative Changes

1. TCJA of 2017
2. SECURE Act of 2019
3. CARES Act of 2020

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Tax Cut and Jobs Act. The Tax Cuts and Jobs Act (TCJA) of 2017 gave us the qualified business income deduction, increased the standard income tax deduction, and for estate and gift tax, increased the basic exclusion amount to $10,000,000 indexed for inflation.

The high exclusion amounts sunset in 2025 and revert back to the pre-TCJA $5,000,000 exclusion amount indexed for inflation.

The SECURE Act. The Setting Every Community Up for Retirement Enhancement (SECURE) Act made some significant changes to rules for retirement plans. For example, the SECURE Act changed the beginning date for required minimum distributions from IRAs from 70 ½ to 72. It also eliminated restrictions on contributions to IRAs after 70 ½.

With respect to beneficiary planning, The SECURE Act substantially changed "stretch" planning. Prior to the SECURE Act, a designated beneficiary could use his or her life expectancy to calculate required distributions. Now, a designated beneficiary, with limited exceptions, must take all distributions within ten years of the plan participant's death.

The CARES Act. The Coronavirus Aid, Relief, and Economic Security (CARES) Act was enacted in response to the coronavirus pandemic and provided direct stimulus payments for those making less than $99,000. To help small businesses, it provided the Paycheck Protection Program to provide eligible small businesses with loans for payroll along with a loan forgiveness mechanism.

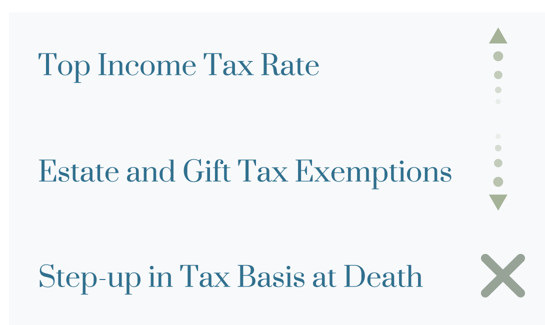
For 2020, the CARES Act waived required minimum distribution requirements for individuals over 70 ½ and provided for a distribution of up to $100,000 for those under 59 ½ without the 10% penalty for early withdrawal. The Act also increased the limit for deducting cash contributions to charities in 2020 from 60% of AGI to 100% of AGI.

CHANGES ON THE HORIZON?

The 2020 Election. Many watched the 2020 election for insights into future tax legislation on the assumption that a Democrat-controlled Congress would lead to substantial tax changes.

Control of Congress will depend on two Senate-seat run-offs in Georgia in January. If Democrats won both Georgia seats, the Senate would be split 50-50, leaving the tie breaking vote to Vice President-elect Kamala Harris. The statistical website FiveThirtyEight.com has the candidates in both run-off elections within a percentage point of each other.

Biden Tax Plan. President-elect Biden's tax plan may be indicative of tax legislation we could see as early as 2021.



Under Biden's plan, the top income tax rate for individuals would increase to 39.6% for those with income over $400,000 per year. Dividends and long-term capital gains would be taxed as ordinary income for taxpayers with income over $1,000,000 per year. Adding the net investment income tax of 3.8% would lead to a top rate of

43.4%. Income over $400,000 would be subject to social security tax. Itemized deductions would be limited to $28,000 for income over $400,000

Biden wasn't originally clear on his proposal for estate tax exemptions but since proposed reducing the estate tax exemption to $3,500,00 and increasing the top rate for estate tax to 45%.

A component of Biden's plan which has not received as much attention is his proposal to eliminate the step-up in basis at death for some appreciated assets. He has proposed eliminating the step-up in basis for capital gains exceeding $100,000. For those assets, Biden's plan would mean that certain assets would be taxed twice at death, once at the capital gains rate and then at the estate tax rate. This would pose a significant change to the estate planning landscape as the "step-up" in basis at death has been relied on by beneficiaries for generations.

Plans introduced by Senators Bernie Sanders, Elizabeth Warren, and Cory Booker all reduce the estate tax exemption to $3,500,000 and some reduce the gift tax exemption to $1,000,000. The Sanders, Warren, and Booker plans would also put many grantor trust planning techniques, such as GRATS, insurance trusts, and SLATs in danger.

SAMPLE STRATEGIES

Taking into account the legislative changes over the last three years, the current economic and political environment, and anticipating future tax changes, what are some strategies that clients can consider? We review some below:

Retirement Plans

Changes to Beneficiary Planning. With the new requirement that beneficiaries must take all distributions from an Individual Retirement Account (IRA) within 10 years of the plan owner's death, the SECURE Act has changed beneficiary planning for IRAs.

Before the SECURE Act, planners sometimes used "see-through" trusts to ensure that beneficiaries would "stretch out" their inherited IRAs. Without a trust, beneficiaries could cash out the IRA and pay the associated tax. A see-through trust was one way to ensure that a beneficiary took distributions according to a distribution schedule based on the beneficiary's life expectancy.

Planners used two types of trusts, a "conduit" trust, which effectively passed annual distributions through to the beneficiary but ensured a stretch out, and an "accumulation" trust, which at the cost of greater complexity, provided for the ability to accumulate and withhold distributions within the trust.

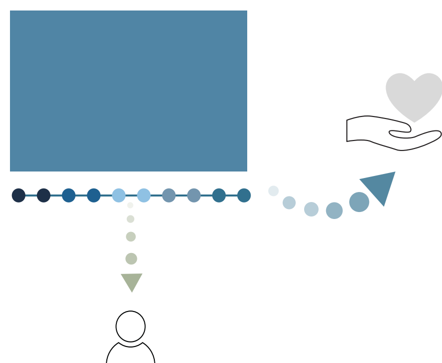
Now, conduit trusts can only provide for a maximum ten year term, and as a result, accumulation trusts may become more common for those plan owners who wish to protect their beneficiaries from unwisely cashing out their inherited IRAs.

Charitable Remainder Trust as Alternative. An IRA owner may look to using a charitable remainder trust (CRT) to replicate an IRA stretch and receive a charitable estate tax deduction.

A CRT is an irrevocable trust that makes distributions to a beneficiary for life or a term not exceeding 20 years. The remainder of assets in the trust are passed to a charity.

In certain situations, despite the remainder gift to charity, CRTs may be structured so that the payments to the beneficiary are greater than would have been if the beneficiary had inherited the IRA. CRTs are tax exempt, although distributions to beneficiaries are taxed based on a tiered system.

Charitable Remainder Trust



Roth IRA conversions. Some clients may look at Roth conversions because they anticipate being in a higher income tax bracket in future years, whether because of anticipated tax rate increases or because their income is artificially low because of the covid-related economic environment.

Contributions to ROTH IRAs are made after taxes have been paid. The contributions then grow tax free and are not taxed on distribution; whereas, traditional IRAs are funded with pre-tax dollars, grow tax free, and distributions are taxed at ordinary income rates.

Individuals can convert part or all of their traditional IRA to a Roth. In order to do so, they must pay taxes now.

For those who have other resources to pay the taxes, a conversion may make sense for those that want the flexibility that comes without having to consider taxes, either for themselves or beneficiaries, down the road.

Gifting

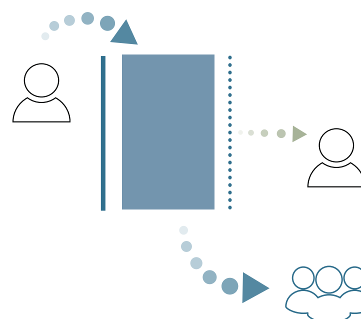
Clients who want to take advantage of the currently high exemption amounts can make large gifts. Regulations have prevented any "clawback" of gifts when exemptions sunset in 2026.

Irrevocable Trusts

Spousal Lifetime Access Trust (SLAT). With the current high estate and gift tax exemptions sunsetting in 2026, possibly sooner, many clients are considering making large gifts but also may be concerned about giving away too much.

For married couples, a Spousal Lifetime Access Trust, or "SLAT", may be an option. A SLAT is an irrevocable trust in which a donor-spouse makes a gift to the SLAT for the benefit of the donor-spouse's spouse. The trust allows the donor-spouse to utilize his or her exemption amount and still have indirect access to the gifted funds.

Spousal Lifetime Access Trust

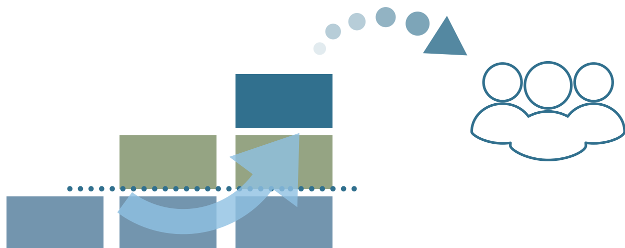


Grantor Retained Annuity Trust (GRAT). Using a Grantor Retained Annuity Trust, an individual transfers appreciating assets, such as marketable securities or closely-held business interest, into a trust in return for retained annuity payments.

The value of the retained annuity is determined by reference to an IRS rate (currently very low). The value of the retained annuity is typically equal to the value of the asset so there is little or no gift. If the grantor survives the term, the asset transfers to the beneficiaries and any appreciation of the asset during the trust term passes estate and gift tax free.

In order for the GRAT to pass appreciation on to the heirs, the rate of return on the asset must be greater than the IRS § 7520 rate which is at historic lows. GRATS are characterized by the adage "Transfer low, let it grow."

Grantor Retained Annuity Trust



CONCLUSION

We have highlighted some of the most significant estate and financial planning developments of 2020. There is still much uncertainty looking forward into 2021 and beyond.

It is reasonable to assume that significant tax law changes are on the way, possibly as early as 2021.

It's also important to remember that, even without significant tax law changes, a new Biden administration may promote changes to Treasury Regulations that impact estate planning.

Those who would be affected by lower estate and gift tax exemptions should consider the looming sunset of the TCJA exemption provisions and should prepare for the reasonable likelihood that Congress may act sooner to lower exemption amounts.

We have highlighted only a few potential strategies and considerations above, and clients should stay in contact with their advisors for new developments.