BLANKROME

Tax, Benefits, and Private Client

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2020 Estate and Tax Planning Newsletter

Blank Rome's annual estate and tax planning newsletter addresses certain concepts and techniques that should be considered in 2020 by our clients and friends in California. Perhaps the most important and troublesome development was the enactment of the SECURE Act discussed in paragraph 1-E-(vii) on page 4.

1. **Transfer Taxes.** The major changes made in 2010 in the law regarding gift, estate, and generation-skipping transfer ("GST") taxes (collectively, "transfer taxes") are now permanent, although any new Congress could amend them (in 2021?). The 2018 Tax Act provided for an increase in the transfer tax exemption from $5,000,000 to $10,000,000 (indexed for inflation[1]) until after 2025.[2]

   A. **Gift Tax.** The tax-free "annual exclusion" amount increased to $15,000 in 2018, and is expected to remain at that level for several years. The cumulative lifetime exemption increased to $11,580,000 in 2020 until after 2025 (indexed for inflation). The tax rate on gifts in excess of $11,580,000 remains at 40%.

   B. **Estate Tax.** The estate tax exemption (reduced by certain lifetime gifts) also increased to $11,580,000 in 2020 until after 2025 (indexed for inflation), and the tax rate on the excess value of an estate also remains at 40%. All of a decedent's assets (other than "income in respect of a decedent," such as IRAs and retirement plan benefits), as well as a surviving spouse's half of any community property assets, still will have an income tax basis equal to the fair market value of those assets at the date of death ["stepped-up (or down) basis"]. In this regard, securities brokers still are required to retain basis records and report the income tax basis of securities to the IRS. **Accordingly, be sure to advise your broker of your basis in securities received by gift or inheritance.** In addition, Executors must report the basis of inherited assets as shown on the federal estate tax return to the IRS and to the beneficiary of the asset.

   C. **GST Tax.** For 2020, the GST tax rate also remains at 40% and the lifetime exemption also has increased to $11,580,000 in 2020 until after 2025 (indexed for inflation). Paragraph 5 on page 6 includes more information about the GST tax.

1. Inflation is now measured using the "Chained Consumer Price Index for All Urban Consumers" ("C-CPI-U"), which will result in lower/slower inflation adjustment. Base year is 2016.

2. Taxpayers who do not take full advantage of the increased exemption amounts before they expire will lose the ability to use the unused portion of the 2018 increases.

D. Portability of Estate Tax Exemption. The "portability" rules provide for the transfer of a deceased spouse's unused estate tax exemption ("deceased spousal unused exclusion amount" or "DSUEA") to a surviving spouse (without inflation adjustments). Thus, if a 2020 decedent's taxable estate is not more than $11,580,000, the DSUEA can be used in the future by the surviving spouse with respect to both gift taxes and estate taxes **(but not GST taxes)**. Portability is not available if either spouse is a non-resident alien. Portability will allow some couples to forgo a more complex estate plan while still taking advantage of both spouses' transfer tax exemptions. Portability must be **irrevocably elected on a timely filed (including extensions) estate tax return, even if a return is not otherwise required to be filed.**

A typical estate plan for a married couple generally has provided for the establishment of two (or three) trusts at the death of the first spouse: A revocable "Survivor's Trust;" an irrevocable "Residual (or "Exemption" or "Bypass" or "Credit Shelter") Trust;" and possibly an irrevocable "Marital (or "QTIP") Trust." One of the reasons for the Residual Trust is to use the deceased spouse's estate tax exemption to the fullest extent possible. Under the portability law, however, if one spouse dies and leaves assets to persons (other than the surviving spouse and charity) in an aggregate amount less than the basic exclusion amount ($11,580,000 in 2020), the surviving spouse in the future may be able to use the DSUEA as well as the surviving spouse's own exemption for gift and estate **(but not GST)** tax purposes.

This portability provision may eliminate the need to create an irrevocable "Residual Trust" at the first spouse's death. For example, if this year the first spouse to die leaves all of his or her assets to the surviving spouse, no part of the deceased spouse's exemption is used because of the marital deduction available for assets passing to a citizen surviving spouse at the first spouse's death. Unless the surviving spouse remarries and survives his or her new spouse, he or she will have an aggregate exemption of (i) $11,580,000 DSUEA and (ii) his or her own inflation-adjusted $11,580,000 exemption ($23,160,000 total in 2020). Similarly, if in 2020 the first spouse to die leaves $1,000,000 to his or her children, the surviving spouse will have an aggregate exemption of $22,160,000 (use of the remaining $10,580,000 DSUEA in addition to his or her own inflation-adjusted $11,580,000 exemption).

In many cases, however, we will advise our clients to continue to use an irrevocable Residual Trust as part of their estate plans for both tax and non-tax reasons. Tax reasons include the following: (i) The DSUEA is not indexed for inflation; (ii) eliminating estate tax on any appreciation of Residual Trust assets at the surviving spouse's death, regardless of the value of the surviving spouse's assets; (iii) allowing for an allocation of the deceased spouse's GST exemption to the Residual Trust;[3] (iv) the surviving spouse could remarry and be limited to using the unused exemption of his or her later predeceased spouse if any (a DSUEA thus may inhibit remarriage); (v) allowing for use of the deceased spouse's California property tax exemptions; and (vi) an estate tax return must be filed timely to qualify for portability.

Non-tax reasons include the following: (i) Limiting (or eliminating) the ability of the surviving spouse to direct the disposition of the deceased spouse's former assets on the surviving spouse's death; (ii) restricting the surviving spouse's right to use principal (perhaps only for health, support, and maintenance); (iii) providing creditor protection (creditors generally cannot reach the assets in an irrevocable trust established by another person); and (iv) providing professional management if desired.

Residual Trust disadvantages include the following: (i) Annual costs for the preparation of income tax returns for the Residual Trust;[4] (ii) the possible loss of a further stepped-up basis on the surviving spouse's death; (iii) lack of surviving spouse ability to change the estate plan to adapt to changed circumstances, unless as is often the case the surviving spouse has a limited power to change the Residual Trust distribution provisions; (iv) lack of ability to offset capital gains and losses realized by the surviving spouse and the Residual Trust[4]; (v) Residual Trust assets generally cannot be used to implement further estate planning techniques; and (vi) the surviving spouse cannot use the $250,000 exclusion from capital gain upon the sale of a residence held in the Residual Trust.[4]

3. **The GST exemption is not portable.** An allocation of a decedent's GST tax exemption to the Residual Trust at death can reduce GST taxes if assets are left to benefit grandchildren, either directly or in a trust benefitting both children and grandchildren.

4. These disadvantages can be eliminated if the surviving spouse has a right to withdraw all Residual Trust income rather than including a provision requiring the trustee to distribute all income to the surviving spouse.

Three Planning Tips. If the reasons for establishing a Residual Trust are not significant, but you nevertheless want to provide for the possible establishment of a Residual Trust in case your spouse later decides that it is advisable to do so, your estate plan can provide for distribution of your estate to your spouse, but include a provision that would allow your surviving spouse to "disclaim" all or a portion of his or her inheritance and arrange for the disclaimed assets to be allocated to a Residual Trust ("Disclaimer Trust"). The surviving spouse could make his or her decision to disclaim during the nine-month period following the first spouse's death. The only difference between a Disclaimer Trust and a Residual Trust established by the first spouse is that the surviving spouse could not have a power to provide for distribution of the assets of a Disclaimer Trust in a manner different from the first spouse's distribution plan.

A qualified Marital Trust ("QTIP Trust") enables a deceased spouse to take advantage of the marital deduction yet still maintain control over the distribution of the trust assets upon the death of the surviving spouse, preserve the deceased spouse's unused GST exemption through a "reverse QTIP election," and provide a greater degree of creditor protection than would be afforded by an outright bequest to a surviving spouse. Using a Marital Trust to accomplish these objectives (rather than a Residual Trust) will allow the Marital Trust assets to receive a step-up in basis upon the death of the surviving spouse and, in some cases, may postpone payment of state level estate taxes until the death of the surviving spouse. In addition, the surviving spouse may wish to elect portability and subsequently use the deceased spouse's remaining estate tax exemption (DSUEA) to make lifetime gifts tax-free.

If a surviving spouse benefits from an existing Residual ("bypass") Trust, and the total of the surviving spouse's assets and the Residual Trust assets is likely to be less than the surviving spouse's estate tax exemption, it might be advantageous to petition the probate court for authority to terminate the Residual Trust in favor of the surviving spouse. If the Residual Trust was created solely for tax planning, and that planning is no longer needed, the court is likely to grant this authority, especially if the surviving spouse has the ability to change the ultimate disposition of the Residual Trust assets by exercising a power of appointment. On the other hand, if there is a blended family and the ultimate beneficiaries of the Residual Trust are different from the surviving spouse's beneficiaries *(e.g.,* children from a prior marriage), the court may not grant the authority to terminate (especially if the step-children file objections to the petition). Alternatively, California recently enacted a "decanting" statue, which allows a trustee to transfer assets from one irrevocable trust to another, subject to certain conditions. Thus, it may be possible to transfer the Residual Trust assets to a "grantor" trust that will allow for a "stepped-up" basis at the surviving spouse's death. Again, there are other reasons to retain a Residual Trust, including creditor protection and the use of the GST tax exemption.

E. Income Taxes. The following is a brief summary of some of the recent changes to federal income tax provisions relating to individual taxpayers:

(i) The highest tax rate (37%, reduced in 2018 from 39.6%) is imposed on 2020 incomes in excess of $622,050 (was $612,350) (joint return), $518,400 (was $510,300) (head of household), and $518,400 (was $510,300) (single). These brackets will continue to be adjusted for inflation annually;

(ii) The 2020 alternative minimum tax ("AMT") exemption amounts are increased to $113,400 (was $111,700) (joint return) and $72,900 (was $71,700) (single), and phase out thresholds are increased to $1,036,800 (joint return) and $518,400 (other than for estates and trusts, which is $84,800);

(iii) In 2020, the standard deduction for a single individual is $12,400 (was $12,200) and the standard deduction for joint filers is $24,800 (was $24,400) (an additional $1,300 deduction still is allowed for each blind and over age 65 taxpayer);

(iv) The 2018 Tax Act repealed the individual mandate to buy health insurance, effective January 1, 2019,[5] and changed the income tax rules for alimony: For divorce or separation agreements executed after December 31, 2018, no deduction is allowed for alimony payments, and no taxable income is recognized when alimony is received. Agreements effective before 2019 are not affected. This recent change in the law can be overcome in appropriate cases via the use of an irrevocable trust for the benefit of the recipient spouse.

5. The Fifth Circuit Court of Appeals has ruled that, because the mandate is no longer a "tax," the Affordable Care Act ("Obamacare") is now unconstitutional. The case was remanded back to the federal district court for further analysis.

(v) The 2018 Tax Act allowed investors to defer capital gains recognized before 2027 by investing in a designated "Qualified Opportunity Zone" (a low-income community). The sale proceeds must be invested in a "Qualified Opportunity Fund" within 180 days from the sale (or date of filing if the gain is reported on a Schedule K-1) in the amount of the gain to be deferred. The deferred gain is taxed upon the later of (a) the sale (or certain other transfers) of the investment or (b) December 31, 2026. But if the Qualified Opportunity Zone investment is held for 10 years, no further gain is recognized upon sale (or certain other transfers) of the investment. The IRS issued final regulations about these investments on December 19, 2019;

(vi) Since tax years beginning in 2018, partnerships have been audited by the IRS under an entirely new regime. Under the new regime, tax adjustments resulting from partnership audits will generally be assessed at the partnership level. This enables the IRS to collect tax due on partnership adjustments at the entity level, thereby effectively imposing an entity-level tax on partnerships. Although it may be possible for a partnership to "push-out" this tax obligation to its partners, this election will result in a higher rate of underpayment interest. The new regime applies to all partnerships regardless of size or number of partners, unless the partnership is eligible to elect out and does so in a timely manner. Typically, partnerships eligible to opt out must have 100 or fewer partners and all partners must be individuals, C corporations, foreign entities that would be treated as a C corporation if domestic, S corporations (although each shareholder is counted as a separate partner for the 100 or fewer requirement), or an estate of a deceased partner. Importantly, partnerships with partners that include other partnerships, single-member LLCs, grantor trusts (including revocable trusts), or nominee partners will prevent a partnership from opting out of the new rules regardless of the number of partners. This new IRS audit regime has created a number of unanswered questions and significant concern over the manner in which partnerships will be audited and potentially subjected to imputed underpayment obligations. Given these concerns, it is very important that all partnership/LLC members discuss with their professional income tax advisors changes to the entity's governing documents that will probably be necessary. The most significant of these changes will be the determination and identification of a designated "partnership representative" ("PR"). Unlike the "Tax Matters Partner" under the formally applicable unified audit procedures, the PR will have increased decision making power and authority that will have significant impact on all owners and the entity in the event of an examination. In addition to the PR designation, there will be several matters the owners will want to consider with respect to various elections, allocations, and the payment of IRS assessments;

(vii) The Further Consolidated Appropriations Act, signed by President Trump on December 20, 2019, includes the "Setting Every Community Up for Retirement Enhancement Act of 2019" ("SECURE Act"). The SECURE Act includes the following provisions among many others relating to retirement plans, effective January 1, 2020:

(a.) Required beginning date for minimum distributions is now April 1 of the calendar year following the year in which the participant attains age 72 rather than 70½, and contributions to traditional IRAs can continue until death, limited by taxable compensation (maximum contribution in 2020 is $6,000 or $7,000 for taxpayers over age 50); and

(b.) All distributions after the participant's death must be made by the end of the tenth calendar year following the year of the participant's death, subject to exceptions for surviving spouses, minor children of the participant (during minority), individuals not more than 10 years younger than the participant, and "disabled" beneficiaries. These "eligible designated beneficiaries" may continue to take distributions over their lives or life expectancies. After an eligible designated beneficiary's death, the remaining account balance must be distributed with the next 10 years. **In order to take this new ("anti-stretch") rule into account, everyone who has planned for post death distributions lasting longer than 10 years must review the beneficiary designations of his or her plan, including the provisions of trusts designated as beneficiaries, and perhaps consider converting a traditional IRA to a Roth IRA or designating a charitable remainder trust or establishing a charitable gift annuity as beneficiary as discussed in paragraph 11 on page 7;**

(viii) In July 2018, the IRS announced a campaign focused on cryptocurrency transactions. Accordingly, taxpayers with unreported virtual currency transactions should consider complying with the tax reporting requirements relating thereto. Although no special voluntary disclosure program exists, in some cases the IRS will discount the penalties for taxpayers who voluntarily amend their prior years' tax returns; and

(ix) In January 2018, the IRS issued a notice to alert delinquent taxpayers who owe at least $50,000 ($52,000 in 2020) that it will begin implementing its right to advise the State Department to revoke their passports. The IRS chief counsel has advised that to date this program has been successful.

2. **Revocable Trust.** The revocable trust is a valuable estate planning technique for both single and married clients, used primarily to avoid the inconvenience and extra costs of a probate administration of an estate upon death (multiple probate administrations would be required if you own property in other states). The same estate tax savings techniques available by Will can be employed via a revocable trust. Many of the post-death income tax advantages previously available to probate estates but not to revocable trusts have been eliminated, thus making the revocable trust even more attractive for wealthier clients. We usually suggest that our California clients use revocable trusts rather than Wills as their primary estate planning vehicles.

   An Israeli income tax may apply to a revocable trust (including those created prior to 2020) of which at least one beneficiary is an Israeli resident, even if there are no assets in Israel, no trustee in Israel, and the trustor is not an Israeli resident.

3. **Annual Gift Program.** A lifetime gift-giving program could reduce overall transfer tax costs considerably. By receiving lifetime gifts, donees will benefit from all future appreciation of and income generated by the transferred property free of transfer taxes. This year, every individual may transfer cash or other property worth **$15,000** (or $30,000 for married couples) to each of as many donees as the donor selects without incurring any gift or later estate tax. An inflation adjustment applies when that adjustment would increase the annual exclusion amount by $1,000 (*e.g.,* to $15,000 in 2018). Donors may make these gifts (known as "annual exclusion" gifts) outright or via custodianships or trusts, although careful planning is needed if trusts are to be used. For example, it is very important to ensure that any trust for a grandchild contains special provisions so that gifts made to that trust are exempt from the GST tax (discussed in paragraph 5 on page 6). In addition, no gift taxes are imposed if you pay a donee's tuition or medical expenses (payments must be made directly to the school or healthcare provider), and you may prepay tuition under certain circumstances.

   Even if a gift is not "tax-free" as described above, if your aggregate gifts do not exceed the $11,580,000 lifetime gift tax exemption amount (or $23,160,000 for married couples), no gift tax will be payable at the time of the gift. Taxable gifts in excess of the $11,580,000 lifetime exemption will accelerate transfer tax payment, but an overall tax savings may result because your gift tax dollars generally will not be subject to estate taxes at death. Use of the increased exemptions before they expire or are modified by a new administration (in 2021?) should be considered because of the "use it or lose it" rule discussed in footnote 2 on page 1. Certain valuation advantages (such as "minority" discounts) that might be unavailable at death often are possible under current law in connection with lifetime gifts (*e.g.,* see paragraph 13 on pages 7-8). Finally, the relatively low interest rates still in effect make this a very good time to loan funds to younger generations, and may make certain types of gifts via trust particularly attractive as described in our "Low Interest Rate Gift Planning" memorandum, a copy of which is attached.

4. **Life Insurance.** Life insurance proceeds are generally exempt from income tax. In addition, all estate tax on life insurance proceeds may be avoided on the death of the insured through proper planning: Insurance proceeds can be available free of estate tax to the surviving spouse, but by designating other family members or a trust for their benefit as owners and beneficiaries, estate taxes can be avoided in both spouses' estates. "Joint life" (or "survivorship" or "second to die") policies make life insurance planning affordable for many more people. You should consider the ownership and beneficiary designations for any newly acquired life insurance carefully before the policy is purchased. You also should review the ownership and beneficiary designations of your existing policies; your revocable living trust or Will does not generally control distribution of life insurance proceeds. "Split-dollar" life insurance plans now are subject to much more stringent rules; we suggest that you review with an insurance professional or with us any "split-dollar" life insurance programs in which you currently participate or in which you contemplate participating. Finally, recent economic activity may have caused your life insurance policies to experience financial problems; you may wish to contact your insurance professional to discuss the current status of your policies.

5. **GST Tax.** The GST tax generally imposes an additional transfer tax (at the 40% estate tax rate) on property transferred to grandchildren and other younger beneficiaries by lifetime gift or at death, and whether outright or via trust. Certain techniques are available to avoid or substantially reduce this GST tax. One technique involves making "tax-free" gifts as described in paragraph 3 on page 5 via an "annual exclusion" gift program to grandchildren (either outright or via trust) and by paying a grandchild's tuition and medical expenses (remember, direct payments to the school or healthcare provider are required). Another technique involves use of your lifetime GST exemption to establish a "dynasty" trust (which can invest in life insurance policies or other property) to enable a substantial amount of property to pass to grandchildren, great-grandchildren, and later generations free of any GST tax. The GST exemption for 2020 is the same as the unified $11,580,000 gift and estate tax exemptions. Whereas use of the gift and estate tax "exemptions" is automatic, use of the GST exemption is elective. In view of the voluntary GST exemption allocation rules, we generally recommend that clients who make gifts to trusts from which a grandchild or other younger beneficiary may receive distributions file gift tax returns (even if not required) in order to specifically elect whether to allocate or not allocate GST exemption to those trusts.

6. **Marital Deduction; Noncitizen Spouse.** The vast majority of married couples combine the estate tax "exemption" granted to each person with the unlimited marital deduction to ensure that no estate taxes are payable until the death of the surviving spouse. The unlimited marital deduction generally is available for gifts and bequests to spouses; those gifts and bequests can be outright transfers or can be made via trusts (although not all types of trusts will qualify for the marital deduction). Severe restrictions, however, are imposed on the ability to defer estate taxes if the surviving spouse is not a U.S. **citizen** (the surviving spouse's residence is not a factor). Under these rules, property passing to a noncitizen surviving spouse must be held in a special type of trust (a "qualified domestic trust") in order to qualify for the marital deduction. In addition, although gift taxes on gifts to noncitizen spouses generally cannot be deferred via the marital deduction, in 2020 you may make "annual exclusion" gifts (discussed in paragraph 3 on page 5) of a maximum of $157,000 (rather than $15,000) to your noncitizen spouse (subject to annual inflation adjustments). As discussed in paragraph 1-D on page 2, portability is not available if either spouse is a nonresident alien ("NRA") (a noncitizen who is not a U.S. resident). You should review your estate plan now if either spouse is not a U.S. citizen.

7. **Estate Planning for a Nonresident Alien ("NRA").** The estate of an NRA has only a $60,000 (not $11,580,000) estate tax exemption available (and no gift tax exemption). U.S. donees of gifts from NRAs or foreign estates in excess of $100,000 [or $16,649 in 2020 (inflation adjusted) from a foreign corporation or partnership] must report these gifts to the IRS on Form 3520. Several interesting planning opportunities may exist for an NRA. An NRA may avoid transfer taxes completely by structuring his or her holdings so that no U.S. "situs" assets are owned directly (for example, U.S. "situs" assets may be held by a wholly-owned foreign corporation, although U.S. real estate presents special income tax issues). If your spouse is not a U.S. citizen, you may wish to defer estate taxes by use of a "qualified domestic trust" (discussed in paragraph 6 on page 6). Lifetime gifts by an NRA of U.S. "situs" **intangible** personal property (such as securities or partnership interests) are not subject to U.S. gift taxes, even though these items would be subject to U.S. estate taxes if owned by the NRA at death. An NRA also may wish to establish a foreign revocable trust to hold property for U.S. family members to provide them with tax-free income and arrange for the trust property to pass to them free of transfer taxes.

   A U.S. taxpayer who expatriates ("covered expatriate") can be subject to severe tax penalties unless that taxpayer has a net worth of less than $2,000,000 and average annual income of not more than $171,000 (subject to annual inflation adjustments). The tax penalties can be deferred on an asset-by-asset basis if an election is made (interest and security are required). In addition, a 40% transfer tax is imposed on the **receipt** by U.S. taxpayers of any amounts in excess of $15,000 (adjusted for inflation) from a "covered expatriate." The IRS issued Proposed Regulations in September 2015 concerning the **donee's** duty to report receipts from a "covered expatriate" on new IRS Form 708 (yet to be released).

8. **Community Property v. Joint Tenancy.** For income tax purposes, both "halves" of appreciated community property receive a "step-up" in basis upon the death of either spouse. Because only one-half of the basis of property held in joint tenancy receives a basis "step-up" at the death of the first spouse, we generally recommend that legal title to *appreciated assets owned jointly by spouses and not held in a revocable living trust be held as "community property" rather than as "joint tenants."* California now recognizes "community property with right of survivorship" as a form of legal title for real estate.

9. **Charitable Tax Planning.** There are several techniques available to transfer significant wealth to intended beneficiaries in a tax-favored manner and at the same time benefit charity. This is particularly true in connection with a sale of highly appreciated assets; a charitable remainder trust can be used to advantage in these circumstances. You also may be able to arrange to receive a lifetime annuity in exchange for cash or appreciated property, or even for agreeing to transfer your residence to a charity at your death (or at the death of the surviving spouse). You also may be able to transfer property to your descendants without (or with reduced) transfer taxes by establishing a charitable lead trust (these are particularly advantageous in a low interest rate environment as currently exists as discussed in our attached "Low Interest Rate Gift Planning" memorandum). The income tax benefits of donating partial interests in tangible personal property items (such as works of art) are currently restricted. The popular "Charitable IRA Rollover" rules were made permanent in 2015; these rules are discussed in paragraph 11 below. Wealthier taxpayers may be interested in a private foundation or a donor-advised fund established at a public charity, such as a community foundation. The IRS has developed two web pages[6] that may be of interest to these taxpayers: "Life Cycle of a Private Foundation" deals with private foundations; and "Life Cycle of a Public Charity" deals with public charities.

10. **"Buy-Sell" Agreements/Options.** A "Buy-Sell" or option agreement (whereby a family member or business associate has the obligation or option to acquire assets at an established price) can be used to advantage in connection with business succession planning to restrict ownership of a business, to establish the value of an asset for estate tax purposes, and to provide a market for the asset to allow owners to plan for liquidity. This estate planning device is subject to restrictions, but some of these restrictions do not apply to agreements made before October 9, 1990. You therefore should be very careful if you wish to modify "Buy-Sell" or option agreements made prior to October 9, 1990. Employer-owned life insurance generally now is subjected to income taxation, **although insurance used to fund a Buy-Sell Agreement is exempt from income taxation, provided that certain written notice and consent requirements are met *in advance.***

11. **Employee Benefit Plans and IRAs.** Assets in pension and profit-sharing plans, IRAs, and other retirement plans (other than Roth plans) can be subject to severe income taxes at death. You should *review your plan benefits to determine whether you can avoid or postpone* these taxes and whether your plan benefits are coordinated with your estate plan; your revocable living trust or Will generally does not control disposition of these benefits. Plan proceeds still can be the most advantageous to use for charitable gifts at death, including transfers to charitable remainder trusts and to establish charitable gift annuities. This is especially true after the recent SECURE Act discussed in paragraph 1-E-(vii)-(b) on page 4. The "Charitable IRA Rollover" provisions were made permanent in 2015, so taxpayers who attain age 70½ (unchanged by the SECURE Act) can direct a maximum of $100,000 (reduced by post age 70½ IRA contributions) to charity from an IRA (only); the payment will not be included in the taxpayer's income for the year, but it nevertheless will count against the taxpayer's "minimum required distribution" for the year. No charitable contribution deduction will be allowed, but most taxpayers nevertheless would benefit by using this technique as opposed to withdrawing funds from an IRA (taxable) and contributing those funds to charity (deductible, but subject to certain limitations).

12. **Subchapter "S" Corporations.** The use of Subchapter "S" corporations has become somewhat less popular because of the increased use of limited liability companies ("LLCs"). Care must be taken, however, with respect to existing Subchapter "S" corporations. For example, upon the death of a Subchapter "S" corporation shareholder, Subchapter "S" corporation status can be lost unless the decedent's shares pass to a qualified shareholder in a timely manner. All Subchapter "S" corporation shareholders therefore should *ensure that their estate plans allow for the continuation of Subchapter "S" corporation status, and consider implementing a "Shareholder Agreement" to restrict stock ownership and perhaps require minimum cash distributions in order to fund required estimated tax payments.*

13. **Family Limited Partnerships and Limited Liability Companies.** A "family limited partnership" ("FLP") or "family limited liability company" ("FLLC") can be an excellent estate planning vehicle for clients who own valuable assets. A FLP or FLLC can be advantageous if a family member encounters creditor problems in the future. Gifts of FLP or FLLC membership interests to your beneficiaries or to trusts for their benefit can qualify for the gift tax "annual exclusion" (discussed in paragraph 3 on page 5) if properly drafted, and the value of those gifts can reflect the "discounts" available for minority and nonmarketable interests. "Discounted" values also can be used in connection with sales to desired limited partners or LLC members, including family members or trusts for their benefit. Some recent IRS challenges to these entities

6. The web pages can be accessed at irs.gov/charities-non-profits/private-foundations/life-cycle-of-a-private-foundation and irs.gov/charities-non-profits/charitable-organizations/life-cycle-of-a-public-charity.

have been successful, however, so all administrative and operational details must be respected; some recent Court decisions have focused on the actual organizational and operational aspects of the family entities. The tax benefits anticipated at the time of the formation of the entity should be available at the donor's death if the entity is organized for a significant non-tax business purpose and operated strictly in accordance with the provisions of the governing instrument and applicable state law, the donor has retained enough assets outside the entity to satisfy the donor's personal financial needs, and the donor is not a general partner or LLC manager.

14. **Durable Powers.** It has become more important to plan for the risk of lifetime incapacity. A Durable Power of Attorney can provide for lifetime asset management, especially if your estate plan does not include a revocable living trust. An Advance Healthcare Directive permits you to designate someone to make healthcare decisions on your behalf if you become unable to do so, and also can be used to make known your desires that artificial life-prolonging measures be or not be employed on your behalf. Appropriate healthcare documents for your children (both minors and adults) also should be completed. A Durable Power of Attorney for Healthcare signed prior to 1992 in California probably is ineffective today. The California Secretary of State has established an Advance Healthcare Directive Registry, and will issue an identification card to each registered person and respond to inquiries by healthcare providers. In addition, **you should consider executing an appropriate Authorization for use and disclosure of health information that otherwise would be protected and thus unavailable under the federal Health Insurance Portability and Accountability Act ("HIPAA").**

15. **Estate Planning Review.** It is always good to review estate planning documents to see if they still accomplish your goals.

    Changes in circumstances, such as a marriage or divorce; a change in financial situation or liquidity; retirement; and births and deaths might necessitate revisions to an estate plan. Life insurance needs also may have changed.

    Old estate plans that make gifts based on formulas tied to an exemption amount that has changed, such as gifts to grandchildren, children from a prior marriage, charity, or others might require revision because the amount of those gifts may be drastically different under current law from what was envisioned.

    Beneficiary designations of retirement accounts and life insurance policies should be reviewed to determine whether they need to be changed [see paragraph 1-E-(vii)-(b) on page 4].

    Legal title to trust assets should be in the name of the living trust. Also, for married couples, how title is held (*i.e.,* joint tenancy or community property) may affect the basis adjustment on the death of the first spouse as discussed in paragraph 8 on page 6.

    Gifts to certain irrevocable trusts, particularly life insurance trusts, might trigger withdrawal rights for its beneficiaries. Written notice of those rights must be given ("Crummey" notices). Failure to send these notices may result in adverse tax consequences.

    Designations of individuals named as fiduciaries (*e.g.,* guardians for minor children, trustees, executors, conservators, financial agents under durable powers of attorney, and health care agents) should be reviewed to ensure that they still are appropriate.

16. **Same-sex Marriages; Registered Domestic Partnerships.** The Supreme Court of the United States has held that same-sex couples have a constitutional right to marry. This decision may significantly impact an estate plan and may have important tax (as well as marital dissolution and property settlement) consequences. Below is a list of some of those consequences, many of which may be retroactive (same-sex married couples may amend previously filed income and transfer tax returns for tax years for which the statute of limitations has not run).

    - The availability of the marital deduction for both gift and estate taxes, including the ability to transmute separate property of one spouse to community property (or vice versa) without negative gift tax consequences.
    - The treatment of retirement benefits and the availability of the spousal rollover IRA.
    - The opportunity to file one joint income tax return or two separate returns as married filing separately.
    - Both spouses may use the gift, estate, and GST tax exemptions, tax advantages of "split gifts" for gift tax purposes, and the ability to use portability.
    - Increased healthcare access and rights.
    - Increased opportunities for international estate planning and citizenship.

17. **Digital Assets.** This is an often-overlooked category of assets that you should consider when creating an estate plan. Many people have many digital accounts, and those accounts may be inaccessible when the person becomes incapacitated or dies. Automatic payments from bank accounts would continue until the bank is notified. California adopted the Revised Fiduciary Access to Digital Assets Act effective January 1, 2017, which will determine who if anyone can access your digital assets. You may use an "online tool" (such as Google's "Inactive Account Manager"), or you may provide for your digital assets in your estate planning documents, or the "terms of service" agreement will govern the disposition of your digital assets.

18. **Deposit Insurance.** The FDIC bank deposit insurance limit is $250,000 per account. Generally, all retirement accounts of a single "participant" at a particular bank are insured up to $250,000. All accounts held by a revocable trust are insured on a "per settlor per beneficiary" basis. For example, a single revocable trust established by a married couple that provides that, on the death of the first spouse, the assets will remain in the trust for the benefit of the surviving spouse for life, and that on the death of the surviving spouse, the assets will be divided into equal shares for their three children, will be insured while both spouses are living for $1,500,000 at each bank in which the trust maintains accounts (husband is treated as having three $250,000 beneficiaries, and wife is treated as having three $250,000 beneficiaries). This rule will apply regardless of the relationship between the trust creators and the beneficiaries; previous law provided for this protection only to certain close family members.

19. **Foreign Asset Reporting.** The Treasury Department is actively pursuing taxpayers who fail to report their foreign assets, including foreign bank and securities accounts and foreign fund accounts maintained outside the U.S. on IRS Form 8938 as required by the Foreign Account Tax Compliance Act ("FATCA"). Filing this Form 8938 does not relieve U.S. taxpayers (including nonresident U.S. citizens and dual citizenship individuals) from the separate obligation to file a Report of Foreign and Financial Accounts ("FBAR") (FinCEN Report 114, replacing Form TD F 90-22.1) that must be **received** by the Treasury Department by April 15 each year (subject to a six-month extension) to report an interest in, or a signature authority over, any financial account in a foreign country if the aggregate value of those accounts exceeds $10,000 at any time during the calendar year. The FBAR must be filed electronically. These two forms must be filed even if the accounts or assets earned no income. IRS Form 8938 must be filed with a U.S. resident's income tax return if total foreign financial assets aggregate $50,000 at year-end or $75,000 at any time during the year (single or married filing separately) or $100,000 at year-end or $150,000 at any time during the year (joint return). Severe penalties may be imposed for failure to comply with either of these filing requirements. The IRS currently offers its "Streamlined Compliance Procedures," a program designed for taxpayers whose failures to report their foreign accounts were negligent or not willful. The IRS has been auditing taxpayers in a campaign that focuses on people who withdrew from or were denied entry into the agency's closed offshore voluntary disclosure program. The IRS has issued a memorandum outlining new voluntary disclosure procedures that will allow taxpayers to escape criminal prosecution (but generally not avoid penalties). Finally, FATCA, which became effective on July 1, 2014, requires foreign financial institutions to report the identities of their U.S. depositors to the IRS.

20. **Blank Rome LLP Partner Honored Again**. We are proud to advise you that Blank Rome Partner William Finestone (Estate Planning & Probate) was again named as a "Southern California Super Lawyer" by *Los Angeles Magazine* (honoring the top five percent of lawyers in their respective fields as determined by surveys of other lawyers), and he also is included as a "Best Lawyer in America" (Non-Profit/Charities Law and Trusts and Estates) in the 2020 edition of that publication and among "The 2020 Los Angeles' Best Lawyers" as published in *The Wall Street Journal* and many other periodicals.

21. **Regulatory Notices.** We are providing this newsletter and the attachment as a commentary on current legal issues as a service to our clients and friends; neither should be considered legal advice, which depends on the unique facts of each situation. Receipt of this newsletter and the attachment does not establish an attorney-client relationship.

There may be other estate planning opportunities not discussed herein that may be of interest to you. Please call William Finestone to discuss your questions regarding estate and tax planning matters.

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BLANKROME

Memorandum

JANUARY 2020

Low Interest Rate Gift Planning

While you still have all of 2020 to take advantage of annual exclusion gifts ($15,000 per donee) and the increased lifetime gift tax exemption (now $11,580,000 per taxpayer), we recommend that you not wait too long to take advantage of the current low interest rate gift opportunities for a number of reasons, including the advantage that once a gift is made, any future appreciation of the transferred property and any future income generated thereby will escape transfer taxes.

In addition, future legislation could limit your gift planning opportunities. Proposed changes that have been discussed in the past and that are likely to be discussed again include (i) eliminating "discounts" for closely-held business and real estate interests;[1] (ii) prohibiting short-term (*e.g.,* two-year) Grantor Retained Annuity Trusts ("GRATs"); and (iii) limiting the benefits of "defective" grantor trusts and long-term "dynasty" trusts. None of these changes has been enacted yet, but for those in a position to do so, we strongly recommend that you take advantage of your gift tax planning opportunities sooner rather than later, after considering the impact of your gifts on your donees.

Low Interest Rates

On or about the 20th of each month, the IRS issues its "Applicable Federal Rates" ("AFRs") that are applicable for many federal income tax purposes for the following month. These minimum interest rates are a key component in many estate planning strategies, and lower rates provide significant opportunities to shift wealth to junior generations. The AFRs for January 2020 are still relatively low: The rate for a loan of less than three years ("short-term") is only 1.60%; the rate for a loan of between three and 10 years ("mid-term") is only 1.69%; and the rate for a loan of ten or more years ("long-term") is 2.07%.

The rates could rise in 2020. You therefore may wish to take one or more of the following opportunities now:

(i) Establish a GRAT;

(ii) Make "intra-family" loans to your children or grandchildren, or to trusts for their benefit;

(iii) "Refinance" existing intra-family loans that bear higher interest rates; and

(iv) If you have philanthropic goals, consider the following:

   (a.) **Estate tax savings.** A charitable lead annuity trust ("CLAT") is a statutorily sanctioned trust that lasts for a specified number of years and provides for specified amounts to be distributed each year to charity during the CLAT term. Any growth in the CLAT assets in excess of the IRS specified rate (the "7520 Rate," which is 2.0% for January) passes to the non-charitable remainder beneficiaries (*e.g.,* your children) at termination of the CLAT, free of gift or estate tax; and

   (b.) **Income tax savings.** A gift to charity of a "remainder interest" in a personal residence or farm produces better results with lower interest rates. Because your retained use of the realty is equivalent to a retained income stream, the lower the interest rate, the less your retained interest is deemed to be worth (and correspondingly, the more your charitable gift is worth), so your charitable contribution deduction is greater. For example, a donor age 70 who contributes

1. Although the proposed regulations under Internal Revenue Code Section 2704 have been withdrawn.

the "remainder interest" in a $1,000,000 residence not subject to a mortgage to charity in January (2.0% 7520 Rate) will be entitled to an income tax deduction of approximately $760,000 (rather than approximately $480,000 at a 6.0% 7520 Rate).

Transfers to GRATs

By way of brief background, a GRAT is another statutorily sanctioned type of trust (similar to a CLAT) whereby you (the "**G**rantor") transfer property to the trust but **R**etain the right to receive specified payments (**A**nnuity) from the **T**rust for a specified number of years, after which the GRAT property is distributed to your donees. The specified payments are often structured so that, after accounting for the 7520 Rate of return on the property transferred into the GRAT, the present value of the payments you are to receive will equal the value of the property you transferred into the GRAT. When the annuity payments are structured in this manner, the GRAT is often said to be "zeroed-out" because your donees' remainder interest has no value for gift tax purposes; thus, no gift tax is payable and no gift tax exemption is used in connection with your funding of the GRAT. To the extent that the investment return on the GRAT property exceeds the 7520 Rate, value will remain in the GRAT after all annuity payments are made, thereby effecting a tax-free gift of the excess return (provided you survive the GRAT term). Accordingly, to the extent that the investment return of a GRAT established in January 2020 exceeds 2.0%, there will be a tax-free transfer of assets to the ultimate beneficiaries of the GRAT (typically your children).

Intra-Family Loans

As a result of the historically low interest rates, it's also a good time to loan money to younger family members or trusts for their benefit. As noted above, the minimum interest rate in January 2020 for a loan of up to three years is 1.60%, and loans between three and 10 years carry a minimum interest rate of only 1.69%. To the extent that the loan recipients are able to invest the borrowed funds and generate a return greater than the minimum interest rate, wealth will have been successfully transferred without any gift tax.

For example, if a loan of $1,000,000 were made for 35 months at 1.60%, and if the borrower invests that $1,000,000 in an investment earning 5.0% after taxes, the excess after 35 months of $99,166 will have been transferred to the borrower free of gift tax.

Finally, if you currently hold an outstanding promissory note that has an interest rate significantly higher than current interest rates, you can refinance that note now to generate additional cash for your donee and reduce your taxable income.

"Defective" Grantor Trusts

Instead of making loans or gifts directly to family members, a more tax-effective option is to make loans or gifts to a "defective" grantor trust for their benefit. A "defective" grantor trust is a type of trust in which all income is taxable to you individually, even though that income inures solely to the benefit of the trust beneficiaries. This in effect permits additional "gifts" to the beneficiaries (in an amount equal to the income taxes) without your being considered to have made any further taxable gifts.

Similarly, it may also be appropriate to sell assets to a "defective" grantor trust in exchange for a promissory note. No taxable gain is recognized by reason of that sale, and no taxable income is recognized by reason of your interest receipts. If the assets that are sold to the trust appreciate at a rate that exceeds the currently low minimum interest rate, wealth will inure to the benefit of the next generation without the imposition of gift tax.

Possible Disadvantages

Once you make a gift, you of course lose access to that property. You should not give away property if you may need it someday, although you should be able to borrow funds from the gift trusts that you have established. If paying additional income taxes by reason of a "defective" grantor trust later becomes burdensome, you can release the "defective" feature to eliminate the imposition of future income taxes.

The recipient's income tax basis in property received by gift generally is the donor's basis; thus gifts of high-basis property are more tax-efficient. If you have created a "defective" grantor trust with low basis assets, you later can exchange cash or higher basis assets tax-free for the low basis assets originally given to that trust. You may be able to borrow cash for this purpose.

Finally, if the property loses value after the gift, you will have used more exemption by making the gift than would be used at your death.

If you wish to pursue a gift-giving strategy in 2020, please call William Finestone to arrange for a meeting to discuss your questions and comments.

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