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Your Clients Want a KISS Plan, but the IRS May Have the Last Dance—Planning for Simplicity and Tax Efficiency, for Clients who May Not Have to Pay Estate Tax

National Association of Estate Planners & Councils (NAEPC) Webinar

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We Got the Beat—Overview

- Current gift, estate and GST exemptions of $12.92 million per person in 2023
- Current exemptions “sunset” in 2026, dropping back to a $5.0 million plus indexing – perhaps $7 million per person
- 40% tax above exemption
- Reduced by taxable gifts made during life
- Portability for estate tax exemption (which the surviving spouse can use to apply to lifetime gifts), but not GST tax exemption or state estate tax exemptions
- Planning under today’s law looks very different than it may in the future
- How can we plan for both today and 2026 (or before)?

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We Got the Beat—Overview

Clients are saying let’s Keep It Simple Stupid!

- Leave all outright to spouse or children, but…
- We want a back-up plan if things change in the future!
- Portability and disclaimers are key to this approach
- And clients need to hear about all the options to make the best decisions for them because dance just isn’t that simple after all

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Portability Overview – Keeping Time

- Portability lets us transfer any unused estate tax exemption to the decedent's surviving spouse
- The surviving spouse "tacks" that unused exemption onto the survivor's own exemption to use during life or upon death
- Property included in the surviving spouse's estate gets a second basis adjustment ("step up", or "step down") at the surviving spouse's death, an income tax benefit perhaps
- Clients like the simplicity of portability—leave it all to my spouse outright or to a QTIP-able trust
- No need to "balance" estate between spouses

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What's the Next Move? Making the DSUE Election

- The DSUE election must be made on a timely-filed estate tax return due nine months after date of death, but an automatic six-month extension can be filed. Also, under Rev. Proc. 2022-32, if the estate is not required to file an estate tax return, the executor has five years from Decedent's date of death to file the estate tax return and make the DSUE election.
- Discretionary extensions are provided, but in very limited circumstances, and only where the estate was not above the filing threshold
- To apply for an extension, you must file a Private Letter Ruling request, and the user fee is substantial.
- If your plan relies on DSUE, do not forget to file!
- The DSUE election is irrevocable.

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Making the DSUE Election

- No “protective” or “formula” election required
- If the 706 shows a DSUE Amount (or no DSUE Amount) but the return is adjusted later and the DSUE Amount is increased (or comes into existence), the full DSUE Amount is automatically provided for if no election out is made
- Easy!

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Making the DSUE Election

- A "full DSUE" plan can use a QTIP-able trust
- Rev. Proc. 2016-49 confirmed that the first deceased spouse can leave surviving spouse a "QTIP'able" interest (a lifetime income interest in a qualified trust), elect to QTIP the entire amount, and port the predeceased spouse's entire exclusion amount to the surviving spouse (i.e., up to $12.92 million in 2023)
- The QTIP'ed assets are included in the estate of the second spouse to die and receive a second basis adjustment

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Making the DSUE Election

- To elect DSUE, the executor must file a "complete and properly prepared" 706, and that standard is determined case by case – no elaboration was made in the Final Regulations
- But there is a special rule on valuing assets if the return is filed only to elect portability, and is not otherwise required to be filed
- In that case, under Treas. Reg. §20.2010-2(a)(7)(ii)(A), property that qualifies for the marital or charitable deduction **does not have to be valued in most circumstances, but think about substantiating basis.**

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Potential DSUE Tangles

- Not filing timely
- Where a DSUE election is made, the regulations do not limit a future examination to DSUE only – the whole return remains open
- DSUE can be “lost” due to a subsequent marriage—DSUE is limited to the DSUE of the last surviving spouse (or it can be increased)
- What if the law changes?
- Outright legacies do not have creditor protection
- Surviving spouse can re-write the plan if outright
- What if the surviving spouse moves to a state with a state death tax?

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DSUE Dance-Steps in Time

- Income tax analysis is important when considering portability. Here are some key factors:
- Step-up (or step-down) in basis under IRC §1014 – compare capital gains tax to estate tax
- Trusts hit the highest income tax brackets quickly and also draw the net investment income tax more quickly
- Higher taxes can result for S-Corporation stock held in an ESBT or QSST due to lost deductions in addition to hitting higher rates more quickly
- Outright legacy to the surviving spouse or children means one less tax return!

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Internal Revenue Code Section 2518 – Qualified Disclaimer Requirements—No Missteps Allowed!

- Must be in writing, identifying the disclaimed property and signed by disclaimant (or legal representative)
- Delivered to the transferor
- Delivered within nine months after the later of:
  - Date of the transfer, or
  - Disclaimant’s 21st birthday
- When does the nine-month clock begin to run?
  - Sooner than you think, in many cases
  - Consider interests in trust that seem “deferred” but are created upon the original transfer

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Internal Revenue Code Section 2518 – Qualified Disclaimer Requirements—No Missteps Allowed!

- No acceptance of the interest or its benefits
  - Exceptions exist – fiduciary role doesn't preclude
  - Use of community home
- Disclaimed property passes without direction of the disclaimant to either:
  - Spouse of decedent, or
  - A person other than the disclaimant
- Special rule for spouse allows for planning flexibility
- Consider severable interests—income only, principal only
- Allow time for successive disclaimers
- No direction means limited powers over disclaimed property

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‘KISS’ Planning – Basic Box Step

- Assume clients, Louis & Linda, have $15 million together, as community property
- Estate plan is structured as a simple plan so that at Louis’ death, all assets pass outright to Linda – they want to Keep It Simple for my Spouse
- Planning goals are: no trust to fund or administer, no additional income tax return to file, all assets get a second “step up” (or down) in basis, one set of accounts….
- Easy! Just file a 706 and elect DSUE
- If Linda wants to make gifts, she can use the DSUE

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‘KISS’ Planning – Add a Back(stop) Beat

- Assume clients, Louis & Linda, have $15 million together, as community property
- But they know life never goes as planned
- Estate plan is structured as a simple plan so that at Linda’s death, all assets go outright to Louis – but they want a back-up plan
- What if exemptions drop and funding a trust will allow appreciation to escape estate tax? DSUE is “frozen”
- GST allocation may become important and you may want to use a state estate tax exemption

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‘KISS’ Planning – Add a Back(stop) Beat

- Include a Marital Trust—if Louis disclaims his outright legacy,
  - assets can pass to a trust for Louis as income beneficiary for life,
  - with children as successor income and also principal beneficiaries
  - watch out for powers of appointment and disclaim those
- The special rule for spouses lets Louis disclaim the outright gift but still accept the income interest in the Marital Trust
- Louis can “over QTIP” or not—Linda’s property can fund the trust and it won’t be taxed at Louis’ death; balance to DSUE

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‘KISS’ Planning – Add a Back(stop) Beat

- The Marital Trust is QTIP-able, but what if Louis wants to be able to make distributions to the children from the trust
- if Louis disclaims the mandatory QTIP distributions,
  - he can still accept a HEMS income interest, if it is a severable interest
  - the principal beneficiaries may be concurrent income beneficiaries so Louis can make distributions to them
  - Consider any state estate tax implications
- Now, we’ve got room to really move!

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Get in a GST Groove

Louis and Linda’s daughter Lana is likely to have a taxable estate, and she doesn’t want her share of the trust assets included in her estate

- If Louis renounces his outright legacy and it passes to the Marital Trust (and “over QTIP” or not)
- If Lana’s income interest is a “severable interest” from her principal interest, Lana, as a vested principal beneficiary, can renounce her principal interest, allowing her children to become principal beneficiaries in her place but retain her income interest
- GST exemption can be allocated to the trust at Linda’s death—it is not portable and otherwise would be lost in an outright legacy
- Allow time for successive disclaimers—Louis and Lana both have to disclaim within 9 months of Linda’s death

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Get in a GST Groove

- What if Lana is named as successor trustee? Any powers she needs to disclaim?
- What if Lana has received distributions, income or principal, before she renounces?
- What if Lana wants to disclaim only half of the vested principal interest and direct half to a QTIP trust for her husband at her death?
- How would the options differ if Louis was sole beneficiary for life with assets distributed to Lana or alternatively, to Lana's descendants, by representation, at Louis' or Lana's later death?

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KISS Missteps??

Tax considerations

- What if the survivor accepts property, perhaps by mistake, and then subsequently wants to renounce?
- Risks to relying on portability, such as remarriage erasing "ported" exemption if new spouse dies
- Ability to use powers of appointment may be lost
- State estate tax considerations
- Retirement accounts, annuities, life insurance and jointly-titled assets all must be coordinated for disclaimer planning

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KISS Missteps??

Practical issues

- Will the surviving spouse be comfortable renouncing to save taxes?
- Emotional toll of major decisions after the loss of your spouse.
- Complexity of disclaiming jointly held assets, community property or retirement assets.
- Family harmony considerations.
- Asset protections considerations.

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Disclaimer Disco

- What should the wills provide to enable Linda or Louis to disclaim from the Marital Trust into the Family Trust? Remember the "no direction" limitations
  - Consider distributions standards--HEMS
  - Trust termination provisions
  - Power to modify/limited power of appointment for HEMS only
  - An independent trustee for these power?
- Automatic division of trust as to disclaimed/not disclaimed property
- Fiduciary concerns?

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“Limboing” under the Bar

Make lifetime gifts now to capture the larger exemption amount and remove appreciation

- Annual exclusion is $17,000 in 2023 ($34,000 for couples)
- Tuition and medical payments, including 529 plans and health insurance premiums
- Grandparent gift and estate planning
- Spousal Trusts
- Charitable Planning
- Planning with retirement accounts
- Other advance planning like GRATs, Gifts and Sale to Grantor Trust, QPRT
- Spend your money!

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Classic GST Trust For Children and Grandchildren

- The trust provides income and, if necessary, principal distributions to child for life.
- At child's death, property passes to grandchildren without being taxed in child's estate.
- Distributions can be made to grandchildren during child's life, if desired.
- Child can be a trustee by will or established during life.

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Grandma Knows How to Boogie

- Grandparent can be the account owner of § 529 Plan and control distributions and name a successor account holder.
- Grandparent can make 5 years of annual exclusion gifts at one time.
- Providing for education can be a great "gift" to children.
- Grandparent can use "extra funds" in one plan to benefit another grandchild.
- Funds grow tax free and qualified distributions come out tax free.
- No additional income tax returns are required.
- Funds are available for higher education only, not high school.
- Funds can be used for more than just tuition, such as books, fees, supplies, room and board.
- Funds don't come to client's hands when they are subject to estate tax and makes room for client to make gifts too.

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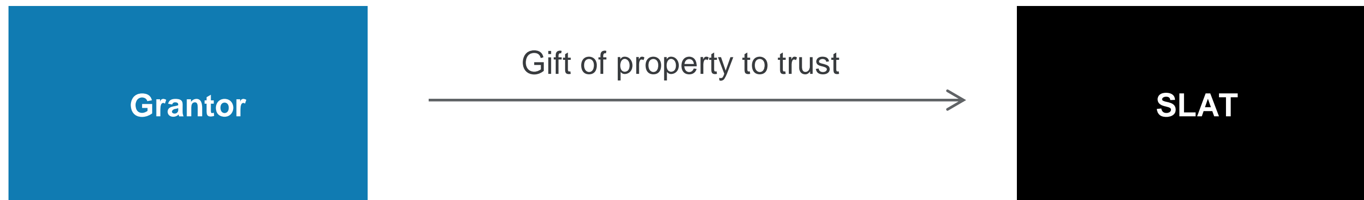
“Spinning” with Spousal Access Trust (SLAT)



Key elements:

- A SLAT is an irrevocable trust.
- It is typically funded via gifts using grantor’s available exemption from gift/estate taxes.
- Grantor’s spouse is a trust beneficiary, thus allowing distributions of income and/or principal to spouse should such distributions be necessary or desired.
- The beneficiaries also can include the grantor’s descendants or other individuals/entities.
- Trust assets and appreciation are not subject to further gift or estate taxes to the extent they are not distributed from the trust.
- Upon the spouse’s death, the trust typically continues or distributes its assets in favor of grantor’s issue or other intended beneficiaries.

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“Spinning” with Spousal Access Trust (SLAT)

Advantages

- A SLAT allows the grantor to efficiently transfer wealth and still provide benefits for the grantor’s spouse as a trust beneficiary.
- Trust can be designed to last multiple generations and can be further protected from tax with the allocation of the generation-skipping transfer (GST) tax exemption.
- Trust can be structured as a grantor trust for income tax purposes, which allows the trust assets to grow without the burden of income taxes; income realized by the SLAT, however, is taxable to the grantor.
- Grantor’s spouse may serve as the trustee if distributions are limited to an ascertainable standard (e.g., health, education, support, maintenance) or can serve alongside an independent trustee to allow for broader distribution powers.

Disadvantages

- Grantor will lose indirect access to trust assets if the grantor’s spouse predeceases him/her or the couple divorces; this issue may be mitigated if each spouse creates a SLAT for the other or in some states that allow for options to use trust protectors or powers of appointment to create trusts that may include the grantor.
- If two SLATs are created, one for each spouse, the trusts cannot be identical, and it is critical to work with a qualified professional when structuring such trusts so they are not collapsed.

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Charitable Cha-Cha

- Claudia is a single mother
- At death, she wants her estate to go one-half to her adult daughter and one-half to her adult son
- Claudia’s contingent legatee is her private foundation
- Claudia’s estate is $10 million
- Claudia would like each child to have the option to renounce assets and have the renounced assets pass to charity

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Charitable Cha-Cha

- Claudia's children may have taxable estates, considering what they inherit from Claudia
- Claudia's children have high income but their deductions do not exceed the current standard deduction—they do not itemize
- The children don't benefit from charitable income deductions yet they do make significant charitable gifts

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Charitable Cha-Cha

- Can Claudia's will be structured to permit flexibility to renounce to the foundation? What restrictions apply?
- Why might Claudia prefer to permit the children to renounce into a Donor Advised Fund?
- What if Claudia is still married and wants her surviving spouse to have the flexibility to renounce funds in favor of either charity or their children or both? Any way to accomplish?
- Better assets to use to fund charitable goals?

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Retirement Account Rumba

- Jacques dies with a non-taxable estate, including a substantial IRA; Jacques was married to Jeanne, and they have three children
- Jeanne may or may not want to accept the IRA
- Two of the children do not have taxable estates and are inclined to accept, if Jeanne renounces
- Third child, Pierre, has a large taxable estate of his own and is inclined to renounce, particularly the income-tax laden IRA
- Jacques' IRA designated Jeanne as his primary beneficiary and as secondary beneficiaries designated one-third of IRA benefits to each of Jacques' three children

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Retirement Account Rumba

- Can Jeanne renounce? What would are pros/cons?
- Benefit to Pierre of renouncing his successor interest in the IRA? Process for renouncing? What happens upon renunciation?
- Different if goes to “closest descendants, equally by representation" or "one-third to [each child]”? What if no contingent beneficiary is listed?
- What if IRA names Jacques’s five grandchildren as contingent beneficiaries?
- What are some ways to complete beneficiary designations in order to maximize flexibility with renunciations?

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Grooving with Grantor Trust Sales

- Settlor establishes a funded "grantor" trust and sells assets to the trust for a note.
- A "grantor" trust is a trust with a certain tax status that treats the settlor as the owner for income tax purposes. Because the grantor is selling the assets to a grantor trust, there is no income / capital gains tax on the sale. If the assets are sold during the term of the trust, the settlor pays the capital gain; the settlor picks up all the income during the term of the trust.
- The trust should be funded with sufficient assets to secure the note and provide economic support for the loan. Funding usually requires a gift by the settlor.
- Goal: freeze the value of the assets transferred as of the date of transfer to avoid inclusion of appreciation in the settlor's estate.

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Grooving with Grantor Retained Annuity Trusts (GRATs)

- Donor transfers property to a trust and the trust pays a determined annuity amount to the donor every year for a set term.
- At the end of the term whatever principal is left goes to the principal beneficiaries free of tax.
- You can structure the GRAT so no gift tax is paid.
- The annuity amount is calculated based on a set interest rate determined by the government each month. No commercial annuity is involved.
- Your beneficiaries “win” if the assets you transfer to the trust appreciate more quickly and at higher rates than the government interest rate predicts.
- You lose (but only the money you spent setting up the GRAT) if the assets do not beat the government interest rates because all of the assets will be returned to donor.

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GRATs

- GRATs can work great, consider:
    - A $5 million transfer
    - A 5% government interest rate
    - Assets that appreciate at 10% per year for 5 years
    - An annuity to donor of $5.0 million over 5 years
    - Transfers about $1.12 million to the beneficiaries with no tax
- GRATs can flop:
    - A $5 million transfer
    - A 5% government interest rate
    - Assets that appreciate at 3% per year for 5 years
    - An annuity to donor of $5.0 million over 5 years
    - Leaves nothing for the beneficiaries

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GRATs

- You may also lose if the donor dies during the term of the trust. The IRS has argued that the entire value of the trust is included in the donor's estate.
- GRATs usually don't work to benefit grandchildren because of GST tax issues.
- The assets may be re-valued following a gift tax audit, and additional assets may be returned to the donor via an increased annuity.

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The Qualified Personal Residence Trust (QPRT) Quickstep

- Donor transfers personal residence (often a vacation home) to a qualified trust for a term; at the end of the term, the principal beneficiaries receive the property.
- Donor makes a gift of the value of the remainder interest only -- the actuarial value of the donor's retained right to use the property for ten years reduces the value of the gift.
- Goal: transfer assets for a lower transfer-tax cost; move appreciation out of donor's estate.

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QPRT

- QPRT example:
  - A $2 million vacation home is transferred
  - 5% government interest rate applies
  - The trust has a 5-year term and the donor is 60
  - The value of the gift is approximately $1.47 million
  - At the end of the 5-year term, the property is worth $3 million, and at the donor's death 10 years later it is worth $5 million
  - A $5.0 million asset is transferred using only $1.47 million of the donor’s estate/gift tax exemption.

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The Last Waltz

- Even more dance steps than before
- Build in flexibility to follow the changing music
- Income tax / capital gains each have a riff
- Don't let the tax tap waltz the dog?

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- Partner with Jones Walker LLP in New Orleans, Louisiana, and serving on the firm's Board of Directors
- ACTEC Fellow, currently serving as the Louisiana State Chair and on the Board of Regents
- Listed in the *Chambers High Net Worth Guide* for Private Wealth Law
- Appearing here between Mardi Gras and Jazz Fest

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