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Dear Clients and Friends:

This note is intended to provide guidance for planning as we approach the November elections and the prospects for tax reform. It is only intended to present the issues and a framework for understanding its relevance to and impact on you, and is neither comprehensive nor directed to your specific circumstances. Some believe there has never been a more urgent time for use of existing tax exemptions, before they are sharply curtailed. This as well as the threat of the potential elimination of certain traditional estate planning techniques is motivating many to act now and before year-end. As such, if after you review this information you would like to meet to discuss your particular circumstances, please contact us. We encourage meeting sooner rather than later, as there will likely be high demand and a rush as the elections approach

Democratic Party proposals have included a call for reduction of the estate, gift, and generation-skipping tax exemptions by nearly 70%, from their current $11.58 million to $3.5 million. This results in approximately a $3.5 increase in estate taxes on individual estates worth $11.58 million or more and assumes no increase in tax rates. Democratic proposals, however, increase the estate, gift, and generation skipping tax rates above their current rate of 40%. Joe Biden has not yet adopted these proposals, but has called for recognition of capital gains in property comprising an estate on death. There is also a belief that whether or not a Democratic controlled government is empowered, that our budget, debt, and deficits will require tax increases. How and on whom they will fall is anyone's guess but taxing the wealthiest is politically most advantageous. Should this occur, legislation could be passed in 2021 and made retroactive to January 1, 2021.

As a result of these circumstances, those who have potential taxable estates may wish to act now by using any number of traditional estate planning techniques that best fit their circumstances. A taxable estate includes all assets owned by an individual, including homes, retirement plans, investments, and life insurance. It also includes prior taxable gifts. (A taxable gift is one that exceeds annual exclusion gifts and certain others.) Therefore, after considering a person's age, their current taxable estate, and a projected growth factor, a projected taxable estate can be determined and if it exceeds $3.5 million ($7 million for a couple) it may be prudent to act. The following reflects a summary of some strategies that one might wish to employ in these circumstances:

A. Reciprocal Trusts. The problem with a gift designed to use your current $11.58 million exemption is that you lose the income. You cannot gift property and retain the income, without that property being taxed in your estate. The Internal Revenue Code ("IRC") prohibits this and forces inclusion of the gifted property in your taxable estate. What if a husband and wife (or anyone with another) agrees to mutually settle a trust for each other with the income payable to the donee spouse, as a beneficiary? If a husband and wife did so for each other,

they have retained the same level of income they had before their mutual gift to each other, in trust. If it weren't in trust, they would own it at death and it would be part of their taxable estate, so gifting in trust is the key to this planning. By having it in a properly structured trust, one would think it wouldn't be taxed in the other's estate. Furthermore, with appropriate planning, that income could extend to the surviving spouse after a death. This would be a great strategy for a married couple to use in order to shelter $23.16 million from the estate tax system. However, it violates the so-called "Reciprocal Trust Doctrine" and doesn't work. It is simplest to understand this doctrine by considering it an agreement and not a gift, and the courts consider the income retained in the gifted property by uncrossing the gifts. In other words, you are deemed to have retained the income, which the IRC prohibits. The two "*interrelated"* trusts leave the husband and wife "in approximately *the same economic position* as they would have been in had they created trusts naming themselves as life beneficiaries," thus violating the IRC rule mentioned above. *United States v. Estate of Grace*, 395 U.S. 316 (1969). The doctrine has been refined and distinguished since the Supreme Court's decision in *Grace* but remains subject to debate and interpretation. Much of the law in the area focuses on the Supreme Courts use of the word "interrelated" and the phrase "same economic position." The following reflects trust structure design that can be used to avoid application of the doctrine, and is based upon a number of cases since *Grace*:

1. Beneficiaries: If one trust is for the benefit of a settlor's spouse and descendants, while the other is for the benefit of only their descendants, it is unlikely the IRS could argue that both spouses are in the same economic position. Nevertheless, with proper planning access to those financial resources can be gained or restored.

2. Powers of Appointment: In *Estate of Levy v. Commissioner*, the existence of a power in one spouse as beneficiary to appoint the property to others was alone sufficient to avoid application of the doctrine. Powers of appointment are tools we commonly recommend in estate plans to provide flexibility in the future.

3. Distribution Standards: Different standards for distributions from a trust can be created in order to distinguish the two trusts, and to argue that the economic positions of both spouses has changed. For example, one trust can provide that all income is paid to the beneficiary spouse but no principal invasion is permitted, while the other might provide that income or principal is only available for health and support. There are a variety of standards for distribution that can be mixed, in order to avoid interrelation and argue for a change in economic position. For a discussion on trust design and these standards, see our Winter 2019, Client Update**,** which commences on the bottom of the first page, at www.jckempe.com.

4. Trustees: In *Estate of Bischoff v. Commissioner*, the Tax Court suggested that avoiding making each spouse the sole trustee of the trust created by the other would help avoid application of the doctrine. As such, mixing the trustees and potentially having co-trustees or unrelated trustees would help to avoid interrelation and also an argument over whether one's economic position has changed.

5. Timing: Funding trusts at different times can provide an argument that the trusts are not interrelated. *Grace* established that 15 days was insufficient, where the two trusts were identical.

6. Assets: Some commentators argue that the funding of each trust with different types of assets can present defense to the doctrine, particularly if they have materially different economic profiles.

In summary, a husband and wife (or two nonmarried individuals) can establish trusts for each other to utilize their current estate, gift, and generation skipping tax exemptions, provided they avoid application of the Reciprocal Trust Doctrine. Avoiding application of the doctrine is highly dependent on the need for the current income and the timing of distributions. In general, variations between trusts can make them nonreciprocal and can thus avoid application of the doctrine.

B. Gifting Trusts. Gifts of wealth should almost always be made in trust, so as to provide protections to the beneficiaries. These protections are typically aimed at protecting the property gifted from divorce, in-law, creditor, and tax risks, by exempting the wealth from these threats. Nevertheless, a gift once complete severs access to the income by the donor, who cannot in general be a beneficiary while removing the value of the property gifted from inclusion in the donor's taxable estate. But, are there other ways of accessing cash flow if needed? What if the children of the donor as beneficiaries, gifted income being distributed back to the donor? What if the donor borrowed funds from the trust? In general, if property is gifted and the Internal Revenue Service ("IRS") can prove that there was an agreement or understanding that the donor would retain or receive the income, the IRC would cause the property to be taxed in the donors estate, as explained in "**A., Reciprocal Trusts**," above. If though this did not happen immediately but happened in the future and as a result of a change in circumstances of the donor, a defensible position could be taken that there was no understanding or agreement associated with the gift. In essence this would be no different than wealth given to children over their lives being used to help a parent who became in need. Alternatively, the trust could loan needed funds to the donor-parent. As long as it was a bona fide loan with adequate interest, there should be no estate tax inclusion of the trust property in the donor-parent's taxable estate. Whether the loan is bona fide would likely be tested against the solvency of the donor-parent's estate at the time the loan was made, and the debt would be repaid to the trust at death. As such the loan does not increase the donor's estate value and provides a neutral result, while providing the donor-parent with access to needed cashflow. This neutral result is primarily created by our current historically low interest rate environment.

C. Grantor Trusts. Trusts created for others are a common method of transferring wealth. This wealth transfer can be enhanced if the trust does not have to pay income tax on its income. A donor often has a choice of continuing to pay the tax from the income on the property transferred. For example, if the property transferred to a trust generates taxable income of $100,000, the accumulation potential of the trust is reduced by the tax paid and in today's environment by potentially in excess of 37% or $37,000. If however the trust were a "grantor trust," the donor would pay that tax, enhancing the accumulation potential of the trust. The donor's payment is not considered a gift. Democratic proposals have included elimination of these grantor trusts.

D. Qualified Personal Residence Trust. Democratic Party proposals seek to eliminate common estate planning strategies designed to avoid estate and gift taxes. One of the most common strategies is a qualified personal residence trust ("QPRT"). A QPRT is a statutory tool that provides for an exemption from normal rules and is one of the first strategies we recommend for client consideration. They are commonly recommended because of the control of use and sale of the home retained by our clients. The potential tax savings is best

illustrated by example. If a 75-year-old with a $3 million home established a QPRT and survived 8 years (the term is variable and set on establishment) the potential estate tax savings exceeds $1 million.

E. Family Partnerships: Family partnerships are another commonly recommended tool. They are holding company structures that are established for family governance and management of family assets. Their peripheral benefits involve reducing the value of estates. This valuation reduction is artificial and serves to enhance the ability to transfer greater wealth by gift or sale to junior family members. Typically, this enhancement is by approximately 35%. Similar benefits can exist or be achieved with any valuable property that is owned in private companies, such as real estate partnerships or closely held businesses.

F. Sales to Grantor Trusts: In our current historically low interest rate environment, tremendous amounts of wealth can be transferred in a tax advantageous way by selling assets to trusts. These trusts can be part of reciprocal trust planning, or simply used to allow property to grow outside of an estate without making a gift. For example, if an interest in a family partnership or closely held busines
s represents $10 million of underlying property value that is sold to a grantor trust (discussed above), the following potential benefits can be achieved:

1. There is no tax on the sale;

2. The assets grow outside of the senior family member's estate;

3. The trust value is often lower than actual value, by approximately 35% ($10 million can often be sold for approximately $6.5 million, as explained in the discussion on family partnerships above);

4. There is no gift because the senior family member is owed the sale price, often using a promissory note at an interest rate that may be less than 1%; and

5. Should the senior family need extra cash flow, the promissory note (which is often an interest only balloon note) can be prepaid in all or part.

The above reflects an abbreviated summary of planning opportunities that currently exist. It is intended to provide you with a base understanding of the vehicles available to confront tax reform. How they may be used in a particular circumstance requires an evaluation of needs and objectives. We are happy to help with the process.

Best Regards,
Joseph C. Kempe

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