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Using Spousal Lifetime Access Trusts to Lock In High Exemption Amounts

The federal gift, estate and generation-skipping transfer (GST) tax exemptions are at an all-time high—currently $11,580,000 for individuals and $23,160,000 for married couples—but may not remain so for long. Some Democratic presidential candidates advocate steep reductions in the exemptions, and the exemption amounts could be reduced as early as 2021 if next year's elections bring a change in the control of Congress and the presidency. Even if Congress takes no action in the near term, the current exemption amounts will sunset at the end of 2025 and revert to their pre-2018 levels unless legislation is enacted to extend them.

With the future tax landscape uncertain, many wealthy individuals are considering making large gifts to younger family members in the coming year to take advantage of the higher exemptions while they can. The IRS recently issued final regulations confirming that individuals who make gifts to use up the current exemption amounts will not face adverse estate or gift tax consequences (commonly referred to as a "clawback") if the exemptions revert to their pre-2018 levels after 2025.

Some individuals may worry about the economic risk of giving away large sums if their financial circumstances change and they need some of the assets back. One strategy that can help address this concern is a "spousal lifetime access trust" or SLAT. A SLAT is a trust created for the benefit of the transferor's spouse and descendants. Although the person who transfers assets to a trust generally cannot receive distributions from the trust, the trustee can distribute funds to the spouse if needed and the spouse can give the funds to the transferor without gift tax consequences. Any assets that ultimately are not needed by the senior generation can pass to children

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(and if GST exemption is allocated to the trust, grandchildren and more remote descendants) free of estate, gift and GST taxes.

Married couples can choose among several variations of the SLAT strategy. For example, one spouse might create a trust for the other spouse and descendants and give the trust up to twice the exemption amount—i.e., $23,160,000 (based on the 2020 exemption amounts), less any lifetime taxable gifts—by “splitting” the gift on the couple’s gift tax returns to take advantage of both spouses’ exemptions. Under this approach, the transferor spouse would lose indirect access to the trust assets when the beneficiary spouse dies.

To mitigate this risk, a couple might choose instead to create two trusts, with spouse No. 1 transferring his or her exemption amount to a trust for the benefit of spouse No. 2 and descendants, and spouse No. 2 transferring his or her exemption amount to a trust for the benefit of spouse No. 1 and descendants. Under this approach, if one spouse dies, the other spouse will still have access to the assets in the trust of which he or she is a beneficiary. This strategy requires very careful planning, as the IRS may challenge the structure under the “reciprocal trust doctrine”: If the trusts grant each spouse the same or similar benefits, the IRS may argue that each spouse is in essentially the same economic position as if he or she created a trust for him- or herself. As a result, each trust will be subject to estate tax in the spouse’s respective estate. To reduce the risk of IRS attack, it is important to differentiate the trusts, including, for example, by appointing different trustees, giving different assets to each trust and/or varying the dispositive terms of each trust.

Alternatively, spouse No. 1 might transfer assets to a trust for the benefit of spouse No. 2 and descendants, and spouse No. 2 might transfer assets to a trust solely for the benefit of descendants (and not spouse No. 1). This strategy generally avoids the reciprocal trust issue (subject to certain exceptions), but results in one spouse having no direct access to the trust funds.

Regardless of the SLAT variation used, couples should consider what would happen in the event of a divorce and whether to address divorce in each trust agreement. For example, should one spouse continue to be a beneficiary of a trust created by the other spouse after a divorce or be automatically removed? If the spouse continues as a beneficiary, the transferor will continue to be liable for income taxes on the trust’s income and gains after a divorce under the “grantor trust” rules, which cause individuals to be treated as owning the assets of trusts they have funded for income tax purposes under certain circumstances. This may not be the desired result.

Individuals in California and other community property states should also consider the community property aspects of SLATs.

As with any estate planning strategy, the gifted assets should be those that the transferor expects will appreciate in value and the transferor should consider the potential income tax consequences, such as the loss of the step-up in income tax basis at death. Individuals considering large gifts should also be mindful of potential state tax consequences. In New York, for example, if the transferor dies within three years of making the gift, the gifted amount may be subject to New York estate tax under certain circumstances.

If you would like to discuss how you and your family can best use a SLAT or other gifting strategies, please contact your Loeb Trusts & Estates lawyer to discuss the possible benefits (and potential risks).

Non-GST Trusts Can Help Younger Family Members Exploit High Exemption Amounts

Many people of means are making substantial gifts for descendants in order to lock in the benefits of the larger gift tax exemption amounts before they are reduced. Younger family members may not have sufficient assets in their own names to fund a gift of that size, however. One alternative funding source may be a trust, created by a younger family member's parent, that is not exempt from generation-skipping transfer (GST) taxes.

Gift trusts are usually either generation-skipping trusts (sometimes referred to as GST trusts), which at the death of the current beneficiary generation can pass assets to younger generations without any transfer tax, or non-GST trusts, which are subject to a 40% federal GST tax at the death of the current beneficiary generation and each subsequent generation. The tax laws limit how much one can put into a GST trust to the GST exemption amount; as a result, the largest part of inherited wealth for wealthy families is often held in non-GST trusts.

In the right circumstances, it could be very advantageous to distribute funds from a non-GST trust to the current beneficiary, so that the current beneficiary (who might not have sufficient assets of her own) can use those funds to create her own GST trust for future generations, to lock in the benefits of the larger exemption amounts before they are reduced and to also avoid future GST taxes on the trust assets. For example, a beneficiary who is married could receive a distribution of as much as $23,160,000 (based on the 2020 exemption amounts, assuming no prior taxable gifts) and give that sum to a GST trust for her descendants, thereby avoiding a GST tax of $9,264,000 that otherwise would be imposed at her death if that sum remained in the non-GST trust for her benefit. This strategy may even be appropriate for young adult family members who do not yet have children—although in those circumstances, in particular, it is important to draft the GST trust with flexibility.

Distributing funds from a non-GST trust to enable gifts that lock in the current large exemption amounts, while potentially saving millions of dollars of GST tax, is not a "one size fits all" solution. There may be countervailing considerations that should be taken into account, such as the impact on the long-term financial security of the beneficiary and a risk of subjecting the distributed property to claims of creditors or spouses if the beneficiary is having financial difficulties or going through a divorce.

If you are the trustee or beneficiary of a non-GST trust and would like to explore using trust assets for wealth transfer planning, please consult your Loeb Trusts & Estates lawyer to discuss the possible benefits (and potential risks).

New Flat Private Foundation Excise Tax

President Trump signed the Taxpayer Certainty and Disaster Tax Relief Act of 2019 into law on Dec. 20, 2019, as part of the consolidated appropriations bill (Public Law No. 116-94) passed by Congress. Section 206 of the Act simplifies the private foundation excise tax on net investment income imposed by Section 4940(a) of the Internal Revenue Code, replacing the current two-tiered system with a flat rate of 1.39%. Until now, tax-exempt private foundations have been subject to a 2% excise tax on net investment income. This rate could be reduced to 1% in years when a private foundation's qualifying charitable distributions exceeded historical levels, as calculated based on a complicated formula. Calculation and reporting of this excise tax required careful monitoring and, for many private foundations, guidance from outside experts.

This is a welcome change for our private foundation clients. The Council on Foundations and other

advocates for the private foundation sector have long advocated for a single, flat (1%) rate to eliminate the administrative burden. Public charities may benefit from an uptick in grant-making, as foundations may adjust charitable distributions.

The new flat 1.39% tax rate is effective for tax years beginning after the date of enactment of the act.

Proposed Regulations Regarding Gain on Sales of Certain Partnership Interests

In December 2018 the Treasury Department issued proposed regulations clarifying the application of Internal Revenue Code Section 864(c)(8), which was enacted by the Tax Cuts and Jobs Act, Pub. L. No. 115-97, on Dec. 22, 2017. Section 864(c)(8) treats a non-U.S. person who sells or exchanges an interest in a partnership that is engaged in a U.S. trade or business as having income that is effectively connected with the conduct of a U.S. trade or business. This new provision of the tax code overturned a recent Tax Court case that held these sales were generally not taxable to non-U.S. persons except to the extent that the partnership held U.S. real property interests.

Generally, non-U.S. corporations and individuals who are neither U.S. citizens nor U.S. income-tax residents are required to pay U.S. federal income tax only on income that is effectively connected with the conduct of a U.S. trade or business (effectively connected income or ECI) and other income from U.S. sources (commonly called "FDAP income"). For these purposes, FDAP income generally does not include gains from the sale or exchange of property (other than real property, for which special rules apply).

Under Section 864(c)(2) of the Code, however, the gains from the sale or exchange of property that is attributable to an office or other fixed place of business maintained by the non-U.S. person may be ECI, depending on the facts and circumstances. The primary factors in making this determination are (i) whether the property is used in or held for use in the conduct of a U.S. trade or business, and (ii) whether the activities of this trade or business were a material factor in the realization of the gain. Furthermore, under Code Section 875(1), if a partnership is engaged in a U.S. trade or business, a non-U.S. partner of the partnership also is treated as so engaged. Therefore, to the extent that a partnership sells a U.S. business asset for a gain, such gain would flow up to the non-U.S. partner as ECI.

The characterization of a sale or exchange by a non-U.S. partner of an interest in a partnership that is engaged in a U.S. trade or business has been an area of controversy. Before the 2017 Tax Cuts and Jobs Act, the Tax Court, in Grecian Magnesite Mining v. Commissioner, held that gains from the sale of a partnership interest are not U.S. source gains that are attributable to a U.S. trade or business (except to the extent that the partnership held U.S. real property, which is governed by the Foreign Investment in Real Property Tax Act or FIRPTA). The court adopted the "entity" theory of partnerships for these purposes, treating the non-U.S. person as selling an interest in an entity, resulting in non-U.S. source income. (Under the "aggregate" theory of partnerships, the sale would instead be treated as a sale by the partner of his or her share of each of the underlying partnership assets, resulting in ECI.) The court's approach was consistent with the general rule that governs the sale or exchange of a partnership interest provided in Code Section 741, which states that the sale or exchange is treated as the sale or exchange of a capital asset, rather than of the underlying assets of the partnership, subject to certain exceptions codified in Section 751 of the Code.

Section 864(c)(8) effectively overturned Grecian Magnesite. Under this provision, a non-U.S. person who sells or exchanges (for a gain or loss) an

interest in a partnership that is engaged in a U.S. trade or business is deemed to have effectively connected gain or loss. The amount that is treated as ECI (or effectively connected loss), however, is calculated based upon, and limited to, the non-U.S. partner's distributive share of the amount of gain or loss that would have been ECI (or effectively connected loss) had the partnership itself sold all of its underlying assets as of the date of the non-U.S. taxpayer's sale or exchange.

Congress granted authority to the Treasury Department to promulgate regulations under Code Section 864(c)(8). On Dec. 20, 2018, the Treasury issued proposed regulations that provided examples of the computation of a non-U.S. person's ECI, clarified the impact of the new rules on FIRPTA and the coordination between the two sets of rules, set rules with respect to tiered partnerships, and addressed the application of income tax treaties to potentially reduce a non-U.S. person's deemed ECI if the gains are not attributable to a partnership's permanent establishment in the U.S.

Although the proposed regulations help tax practitioners better understand the new rules, certain questions remain, particularly as they relate to the application of Section 864(c)(8) in the context of nonrecognition transfers. The Treasury Department has stated that while it did not provide guidance on nonrecognition issues, it recognizes the potential to abuse the rules under Section 864(c)(8). The department has requested comments from practitioners to determine whether the tax code adequately addresses these concerns and has noted that it may issue additional rules if necessary.

Health Care Documents and Powers of Attorney for Young Adults

You just received the great news that your high school senior has been accepted to college. As you make plans for his sendoff next September, make sure you plan for the fact that he is an adult. While that's hard to internalize, it's a legal fact.

What does this mean for you?

Health Care Documents: A variety of federal and state laws prohibit your adult child's doctor from disclosing "individually identifiable health information and medical records." That means that your adult child could be having serious physical or emotional medical issues, and the college will not be able to discuss them with you. If your child is cooperative, he can sign an Advance Health Care Directive or Durable Power of Attorney for Health Care (the name varies by state, but the concept is the same). This document authorizes the named agent to make medical decisions if the signer is unable to do so. It typically authorizes the release of confidential medical information to the named agent. Completing the form with your child also provides an opportunity to discuss your child's wishes regarding a variety of medical matters. You may not know what he would want, and your child is now an adult.

Power of Attorney: If your child has assets in his own name (such as a bank or brokerage account), it may be helpful for you to be able to sign on that account, particularly if he is attending college far away.

Passwords: Most young adults conduct their lives online. If your son becomes unable to handle his affairs due to temporary incapacity, do you have access to his accounts?

All these discussions require a level of trust, and not every 18-year-old will provide access to medical information, financial information and online accounts. But as you will hear from any helpless parent whose child is in the emergency room after a party that got out of hand, it's worth asking.

Inflation Adjustments for 2020

The IRS recently announced the 2020 annual inflation adjustments for more than 60 tax provisions. Noteworthy inflation-adjusted amounts include:

- The combined lifetime gift tax/estate tax exemption amount will be $11,580,000 per individual (up from $11,400,000 per individual in 2019).
- The exemption for generation-skipping transfer (GST) tax purposes will be $11,580,000 per individual (up from $11,400,000 per individual in 2019).
- The annual exclusion for gifts (which does not count against the lifetime gift tax exemption) remains at $15,000 per donee.
- The annual exclusion for gifts to a spouse who is not a U.S. citizen will be $157,000.
- The top income tax rate of 37% will be reached by married couples filing jointly with taxable incomes greater than $622,050 and by single taxpayers with taxable incomes greater than $518,400.
- The Alternative Minimum Tax exemption will be $113,400 for married couples filing jointly (for whom the exemption will begin to phase out at $1,036,800) and $72,900 for single taxpayers (for whom the exemption will begin to phase out at $518,400).

2020 Election Year Changes – Stay Tuned

Election years bring a renewed focus on tax policies and the prospect of changes to the tax laws that could have a profound impact on tax planning. Election season is also a time when many of our tax-exempt organization clients seek guidance on whether and how to engage in advocacy on social and political issues, conduct voter registration drives, and participate in other election-related activities. As the 2020 election approaches, we will monitor and report to our clients and friends on proposals concerning estate, gift, GST, income and wealth taxes, and we will publish reminders about the campaign-related rules that apply to foundations and public charities.

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