Bloomberg
Tax

Estate Planning Opportunities Under the New Administration

March 24, 2021

By: Henry Montag of The TOLI Center East and Andrea B. Schanker of Schanker and Hochberg P.C.

It is a new year and a new government administration while we still fight to overcome this global pandemic that began a year ago. It is glaringly clear that this past year's Covid-19 breakout, when coupled with the shift in the federal government, has necessitated the acceptance of some "cold, hard, facts." Our clients are vulnerable and need to have a plan to stay safe and protected. This includes proactive planning for purposes of incapacity and death. This includes estate tax considerations and life insurance coverage. So, let's pick up our masks and get to work!

President Joe Biden is now in office, and the Democratic Party holds a slim majority in the Senate. The economy is still depressed for many asset classes. In the world of estate planning, our most anticipated change is that of what will happen to the federal estate and gift tax rules? Currently, the federal estate tax exemption is $11.7 million per person ($23.4 million per U.S. citizen married couple) with a 40% tax on the excess. (Section 2010(c)(3)(B)(ii)) The lifetime gift tax exemption (unified with the federal estate tax exemption) is also $11.7 million per person ($23.4 million per U.S. citizen married couple). (Section 2010(c)(3))

President Biden has been quite vocal about a significant reform to a federal estate tax and lifetime gift tax exemption of $3.5 million per person ($7 million per U.S. citizen

married couple). If nothing is done, then the current law reverts the federal estate and lifetime gift tax exemption back to around $5 million per person ($10 million per U.S. citizen married couple) adjusted for inflation as of Jan. 1, 2026. It is generally accepted to expect a reform within this year, yet unlikely to be retroactive to Jan. 1, 2021.

The effect of this reform would bring in much needed revenue to support the massive expenses of the pandemic as well as President Biden's interest in building out the infrastructure. There is "chatter" about doing away with the "step up" of cost basis upon death for capital assets and replacing it with "carry-over basis" (the beneficiary, at death, inherits the decedent's original cost basis), but this change has never been successful, and it could be inherently problematic.

Now is the time to take action. Review your client's estate plan and make sure it is current. Make sure they can locate their ***original documents***. Enforcing copies of lost wills or not being able to locate a trust causes irreparable harm. Take advantage of the current high exemptions and explore gifting strategies with your clients. Time is really "of the essence" and if they wait too long, opportunities will disappear. The following are some very popular strategies.

'Double Up'! Disclaimer Provisions to a Credit Shelter Trust

This is estate tax mitigation "101." You can double the estate tax (federal or state) exemption between U.S. citizen spouses by having their will/trust specify that at the time of the first death, the surviving spouse has the choice to disclaim an outright all or part of their inheritance to fund into a credit shelter trust for their benefit for the remainder of their lifetime. This trust can be funded with what may pass free from either the state or federal estate tax exemption that is otherwise wasted at the first death because there is an unlimited marital exclusion for any gifts made during lifetime between spouses or any inheritance between spouses. During the remainder of the surviving spouse's life, he/she is a co-trustee to manage the assets in the trust and has access to income and principal for purposes of health, education or support. Upon the second death, despite how much growth and accumulation has been enjoyed, the balance of this trust will pass completely free from any estate tax.

Spousal Limited Access Trust (SLAT)

One or both spouses initiate a trust for the benefit of the other. A gift of assets funds the trust and utilizes the lifetime gift tax exemption. The donor spouse has no direct access to the trust assets, however the trustee does have discretion to make distributions to the non-donor spouse, if necessary. This is a nice way of making an irrevocable gift and still having access to funds at the same time. That said, the marriage better be solid, and a very experienced estate planning attorney is the only qualified attorney to perform this strategy because of some easy pitfalls if not done by someone with the right experience.

Clawback Trusts

A clawback trust is an irrevocable grantor trust currently to be funded with up to what can pass free from the federal exemption. The terms of the trust will have you as both the grantor and the trustee and can name yourself, your children, and grandchildren as potential beneficiaries. The grantor will have control over the income and an independent trustee will have discretion over principal distributions. Although the trust is irrevocable, the assets inside of it will not be shielded from any claims of creditors. By doing so (under the recent claw back regulations from IRS), (See T.D. 9884, 84 Fed. Reg. 64,995 (Nov. 26, 2019)) they are grandfathering into the larger exemption. In other words, when a client dies, if the law does sunset, the estate will be entitled to an exemption of what it was on the date that the gift was made. Although the gift is brought back into the client's estate, it does gain the benefit under the claw back regulations of the expanded exemption. This in essence is somewhat of a way of "having your cake and eating it too."

Valuation Discounts

An entity is formed (commonly known as a "family limited partnership" or "FLP") and there are two level of owners: the general partner(s) who has all of the power and control and the limited partners who have no power or control. An asset (income producing property, investment portfolio, etc.) is gifted into the entity, and the general partner makes a gift of up to 99% to the limited partner(s) (an individual or trust for the benefit of an individual(s) at a value not to exceed the lifetime gift tax exemption). The value of this gift is actually discounted because of the "strings" attached in reference to the limited partners' limitations. The value of the discount is appraised by a qualified CPA, and his/her report justifying the discount is submitted to the IRS along with the gift tax return. This is a very popular method of maximizing the use of the lifetime gift tax exemption.

Life Insurance

Should the federal estate and gift tax exemptions be reduced to the $3.5 million per person, or the step-up basis be taken away, there will be an increased need for the use of life insurance to pay the increased federal estate tax which is due and payable within nine months from the date of death (unless they qualify for Section 6166). Life insurance is an excellent and effective resource to provide the necessary liquidity to pay estate tax (federal and/or state). This is especially applicable when there is a high net worth estate with little liquidity available at time of death.

The question then becomes what type of life insurance works best:

- **Term Insurance** will often expire before the person being insured passes away, as term insurance terminates when the insured is in their early to mid-80s. It is purchased in 5-, 10-,15-, 20-, 25-, and 30-year guaranteed periods. It provides maximum death benefit for the lowest cost. It is ideally suited for short– and mid-range needs such as providing for any loans or funding a buy-sell agreement. It should not be relied upon for any estate planning purpose as it may not be there when needed. Term Insurance should not be allowed to expire or go past its guaranteed conversion period, often 65 or 70, if the insured persons' health has changed, and they may otherwise be uninsurable.
- **Whole Life Insurance** is guaranteed to be in force when needed, simply because this type of coverage costs more than any other type since the policy builds up a significant amount of cash value, which can be beneficial should you want to borrow against it. But, since a beneficiary in most cases won't receive the cash value and the death benefit, it's not at all necessary if you're using it for death benefit protection as would be the case to pay for estate taxes.
- **Guaranteed Universal Life Insurance** allows you to pay the minimal premium to guarantee that the maximum death benefit chosen will remain in force to a specific age. This type of a policy is not to be used to build up accumulated cash value that can be borrowed to supplement one's retirement, or fill other short-term cash needs. However, it is ideally suited to be used to pay for one's estate tax liability, or to make a legacy gift to a beneficiary.
- **Second to Die Life Insurance:** If the client is married the estate taxes are not due until nine months after the death of the second spouse. Therefore, a married couple need only consider a "second to die policy," which pays its death benefit at the death of the second spouse. Life insurance used to pay an IRA beneficiary's future income tax liability is also due each of the first 10 years as it's withdrawn, or no later than 10 years after the second death. These are both perfect uses for a second to die policy. Since the insurance company is insuring two lives the cost to the client is significantly less expensive than insuring the two individuals separately.
- **Existing Life Insurance:** Regardless of the type of life insurance it may be, its performance must be evaluated to determine the duration of coverage for the particular policy. Approximately 60% of existing life insurance coverage is of a non-guaranteed nature and as a result of years of reduced sustained interest rates and neglect on the part of the owners that didn't know they should have paid a higher premium to the insurance company to make up for the interest rate shortfall, an increasing amount of life insurance coverage is expiring years earlier than anticipated. Life insurance has mistakenly been treated as a "buy and hold" asset, when it should have been treated as a "buy and manage" asset, just like any stock, bond, or real estate portfolio. Make certain your client's life insurance doesn't expire before they do, as that type of a mistake can cause a significant financial loss to the family, often resulting in looking for someone to blame, followed by costly estate litigation.

Although the creation of the SECURE Act (Public Law No. 116-94) came about a year before the new administration, it has created a new future tax liability placed on your client's IRA's beneficiaries. The change that is responsible for the largest financial hardship to the clients' beneficiaries is the change to the length of time a non-spouse beneficiary that inherits a traditional IRA must make their distribution and pay their associated tax obligations. The ability to spread out these distributions after the death of the IRA owner for a limitless amount of time was known as the "Stretch IRA." Under the SECURE Act if the beneficiary is more than 10 years younger than the IRA owner, they must liquidate the account within 10 years unless they are a spouse, disabled, chronically ill, or a minor child. (SECURE Act, Division O, Section 401). For example, under the old law, IRA owners could pass their IRA onto their children and grandchildren. The kids or grandkids of IRA owners could stretch the IRA distributions over the life of the beneficiary. What was once a very efficient means of accumulating and allocating assets for members of the next generation is no longer available.

To illustrate the point, if a 25-year-old inherited a $1 million IRA, they would take a distribution over their life expectancy of 57.2 years. Their distribution would be approximately $17,482. The federal tax, assuming a 24% bracket, would be about $4,000. Under the SECURE Act the beneficiary will have to withdraw all the money within 10 years. Thus, the beneficiary would withdraw $100,000 per year and pay $24,000 in taxes each year or withdraw all the money in the tenth year and pay the prevailing tax at that time. One way to offset that $20,000 higher tax burden for each of the 10 years of withdrawals would be for the owner of the IRA to gift IRA assets to be used to purchase additional life insurance $20,000 X 10 years = $200,000 per million to make up for the additional taxes due for the increased distributions, as well as for the higher rates as a result of having to possibly bunch up their distributions over a shorter period of time, particularly if it occurs during their peak earning years. Under the SECURE Act any IRA assets paid to a conduit trust will have to be distributed under the new 10-year period.

Since this future tax liability for the inherited IRA beneficiary (with the exception of a spouse, disabled, chronically ill, or a minor child, or if beneficiary is not more than10 years younger than the IRA owner, as the inherited IRA beneficiary) would be due 10 years after the death of the IRA owner, it would make sense to use the "proceeds of a second to die" life insurance policy to pay for the future tax liabilities imposed by the new tax on the son or daughter that inherits their surviving parent's IRA.

Mr. Seymour Goldberg JD, CPA, a national authority on the subject of IRA distribution planning states: "Estate and Income tax planning regarding IRA distributions are now more important than ever, especially under the Secure Act. IRS compliance is also a major issue in planning for IRA owners and beneficiaries. Steps must be taken to avoid costly penalties."

Conclusion

There are countless advanced planning strategies available which should be evaluated by an experienced trusts and estates attorney and other trusted, experienced advisors. The best advice you can suggest to your clients is that they get organized, update, and review their thinking, their documents, as well as their life insurance policies and take advantage of these valuable opportunities while they are still available.

This column does not necessarily reflect the opinion of The Bureau of National Affairs, Inc. or its owners.

Author Information

Henry Montag CFP, Managing Director of The TOLI Center East in practice since 1984 with offices in Long Island, NY, has authored articles and acted as a source for NYSBA, NYSSCPA Bloomberg Daily Tax Report, & Bloomberg Estates Gifts & Trust Journal, Trusts & Estate Magazine, Accounting Today, & The Wall Street Journal. He has appeared as a guest on Wall Street Week, Fox Business News & News 12. He co-authored an American Bar Association Flagship publication, January 2017, titled; "The Advisors' & Trustees' Guide to Managing Risk" The January 2019 issue of Commerce Clearing House, referred to him as; "One of today's best brains in life Insurance."

Andrea B. Schanker, Esq. is a Partner at Schanker and Hochberg P.C. She regularly delivers estate planning presentations to professionals in the legal, accounting, and financial industry as well as to their clients in matters relating to estate planning, estate administration, business succession planning, and elder law. She is a member of the Suffolk County Bar Association, the New York State Bar Association where she is an active member within the Trusts and Estates Section and the Elder Law and Special Needs Section. She is a past President of the Huntington Lawyers Club and was recently a featured speaker at the NY County Lawyers Association.

Bloomberg Tax Insights articles are written by experienced practitioners, academics, and policy experts discussing developments and current issues in taxation. To contribute, please contact us at TaxInsights@bloombergindustry.com.