13 TAX REDUCTION STRATEGIES THAT MAY END SOON

The pandemic and current political environment are disruptive. However, low interest rates combined with looming reductions in estate tax benefits have focused estate planners on significant opportunities for wealth transfers. As with most opportunities, these benefits will not last very long.

The Current Situation

In 2020, an individual who passes away with less than $11.58 million of assets is likely to avoid the 40% federal estate tax. However, the prospects of maintaining this historically high estate and gift tax exemption are grim. The post COVID-19 relief packages must be funded and income tax revenues are declining. A new administration will be looking for ways to pay for those stimulus payments and will likely consider lowering the estate tax exemption. If Republicans lose the White House and the Senate, and Democrats retain control of the House of Representatives in 2020 elections, the estate tax exemption is expected to be substantially reduced. In any event, under current law the estate and gift tax exemption will be lowered in 2026 to around $6 million ($5 million adjusted by inflation), and it seems likely other estate and gift tax planning tools may be severely limited or eliminated. As explained below, other revenue raising proposals eliminate or severely limit the use of other common planning tools.

Historically low interest rates also offer a once in a lifetime opportunity to shift assets and future appreciation to family members. Federal interest rates are used by the government to determine the minimum interest required to be charged in inter-family loans and to value gifts in certain common planning vehicles used to shift appreciating assets to future generations. Interest rates are certain to increase in the future, so it is a good time to make loans and set up certain wealth-shifting trusts.

13 Strategies to Reduce Taxes

This article discusses 12 strategies to take advantage of the current opportunities before they are lost.

What You Can Do

An individual who wishes to avoid or minimize future estate tax has three basic tools: (1) give away assets at no or low gift tax cost before they appreciate by using available tax exemptions, (2) lower the gift and estate tax value of assets transferred or assets remaining in their estate; and, (3) leave assets to charity. All estate tax planning tools use one or more of these concepts. Below are some tried and true ways to reduce or perhaps eliminate a future estate tax.

Use Current Exemptions to Make Tax-Free Transfers

1. **Use the high $11.58M lifetime estate and gift tax exemption now.** Wealthy individuals should consider using their exemption to remove assets from their estate before the exemption is reduced. The IRS has indicated that the use of high exemptions now will not be lost or “clawed back” if death occurs later when the exemption is lower, so there seems to be little risk to using this opportunity. The high exemption can be used to shelter simple gifts, gifts to trusts or in conjunction with some of the other tools set forth below.

2. **Use the annual gift tax exclusions.** This year an individual can make annual gifts of up to $15,000 in value to any number of people without having to file a gift tax return on the transfers. A married couple can give away $30,000 to as many people as they wish this year without any tax consequence to them or the recipients of the gifts. These gift tax exemptions may be reduced in the future.

3. **Pay educational or medical expenses for family members.** Tuition payments made directly to an educational organization on behalf of a person, and payments for a person's medical care made directly to the provider are not treated as taxable gifts. This gift tax exclusion is in addition to the annual gift exclusion. In some cases it may be allowable to prepay tuition expenses and have that prepayment qualify. This technique removes value from an estate without using any of the $11.58M lifetime exclusion.

4. **Combine the $11.58M Gift Exemption with the high generation-skipping transfer (GST) tax exemption.** The purpose of the GST Tax is to limit the government's estate tax loss if wealthy individuals make gifts to grandchildren or other younger generations and bypass their children. The GST is an added estate tax on such “skip” gifts. Each individual currently has an exemption from GST equal to the estate exemption and can shield $11.58 million worth of transfers to

grandchildren (and other people 2 or more generations below the individual) from the GST tax. The exemption is scheduled to decrease in 2026 and may be reduced or altered sooner. Individuals with significant wealth may take advantage of the high GST exemption during life by making gifts to grandchildren, or setting aside property in irrevocable trusts for grandchildren (or for children and ultimately for grandchildren). A "dynasty trust" extends the shelter of the GST exemption and holds assets for the benefit of multiple generations for the maximum period permitted by law. If structured correctly, there would be no future gift, estate, or GST tax assessed on the property contributed to and held in the dynasty trust or on distributions to the trust beneficiaries. Over many generations, this can shelter very large amounts from transfer taxes.

A revenue-raising proposal would limit the number of generations that can be sheltered by the GST exemption, so it seems appropriate to implement long-term planning before such a change is made.

Use Low Interest Rates Before They Go Back Up

5. **Make low interest loans.** Low interest loans can be made to family members in the current low interest rate environment. Low Applicable Federal Rates make low interest loans an attractive alternative. Intrafamily loans can be useful to children or older family members in need of financial assistance and can be used to refinance existing loans.

6. **Sell assets to family members (or trusts) in exchange for low interest rate notes.** A variant of the low interest rate loan is a sale to a family member or trust in exchange for a low interest rate installment note. This technique can "lock in" the current asset value in an estate and shift the future appreciation to the buyer. The seller also retains some cash flow. In the future, as interest rates climb, the note might be restructured or forgiven over time or at the death of the seller.

7. **Create grantor retained annuity trusts (GRATs).** A GRAT is an irrevocable trust in which the grantor retains an annuity payment for a set term of years. At the end of the annuity period, any remaining property, including all appreciation, passes as to designated beneficiaries, outright or in ongoing trusts. The gift tax value of the GRAT gift is the value of the future gift reduced by the annuity payments. The effect of a successful GRAT is to remove future appreciation of an asset from the estate. GRATs are most effective when interest rates are low, because the assets given to the GRAT do not need to appreciate as fast to yield a successful GRAT result. As a result, GRATs may provide a significant opportunity to shift future appreciation out of an estate while interest rates are low. GRATs are also "grantor trusts" which provides added planning leverage (see below).

Limiting GRATs has been frequently cited as a revenue-raising tool, so the opportunity offered by forming a GRAT may be reduced or lost completely in the future.

8. **Create charitable lead trusts (CLTs).** A CLT is an irrevocable trust benefiting charitable beneficiaries for a specified term of years and at the end of the term, the trust assets (and future appreciation) are distributed to the grantor's family or other beneficiaries. A CLT may also provide a current charitable income tax deduction to the grantor, or the CLT's own income may be offset by a charitable deduction for the charitable payments. Like GRATs, CLTs are particularly effective when interest rates are low because the value of the required payments to charity and the value of the remainder passing to family beneficiaries are determined in part by the federal interest rates. CLTs allow an individual to satisfy charitable intentions and transfer significant property and appreciation to his or her beneficiaries.

Use Grantor Trusts to Leverage Gifts

9. **Gift assets to a grantor trust.** An "Intentionally Defective" Grantor Trust (IDGT) is a trust where the grantor (individual creating the trust) is treated as the owner of the trust for income tax purposes and pays the tax on the trust income. The trust grows without depletion by income tax so more value is passed to the beneficiaries. Grantor trust planning is highly effective in reducing future estate tax and provides great planning flexibility In the future.

Recent revenue raising proposals target grantor trust planning by including all grantor trust assets in the grantor's taxable estate at death. It is expected that any such change would only apply to grantor trusts formed after such new law was enacted, so it may be appropriate to consider grantor trust planning tools now.

10. **Sell assets to a previously funded grantor trust (IDGT sales).** Once an individual makes an initial gift to an IDGT, large amounts of appreciating assets can be transferred out of the individual's estate by selling the assets to the IDGT in exchange for a low interest rate promissory note. There is no capital gain on the sale because the IDGT is a grantor trust for income tax purposes. The note received by the seller pays low interest and only returns the initial value of the assets sold, so the individual's estate value is "frozen". On the other hand, the IDGT's assets grow without income tax. As a general rule, if the IDGT's assets grow faster than the interest rate on the promissory note, the IDGT sale technique is successful. If the sale is of a minority interest in an asset, partnership, LLC or corporation (see discussion below), the use of a discounted value makes the IDGT sale planning even more effective because the value of the promissory note held in the seller's estate is lower, the payments back to the seller are lower and easier to make

from available cash flow, and more assets and future growth will be shifted out of the estate.

It is appropriate to leave time between the formation of the grantor trust and the future sale, so IDGT sale planning needs to begin early.

Using Legal Entities to Manage Assets and Possibly Reduce Value of Future Gifts

11. **Create family limited partnerships and LLCs (for asset management, asset protection and potential reduction of values on gifts).** Forming a family partnership or LLC to hold real property, stock or other assets is an effective tool to transfer assets to family members and retain overall management of the assets. These structures also often allow for tax efficient transfers of partnership or LLC interests to family members at reduced valuations, thereby leveraging the amount that is removed from the estate. Discounted values can usually also be obtained on the remaining partnership or LLC interests left in the estate. A side benefit of forming family partnerships or LLCs is coordinated management and an opportunity for younger family members to be invested and involved in the business.

Forming family business entities properly requires advance planning, so it is not appropriate to leave this planning tool to the last minute.

Take Advantage of Depressed Valuations

12. **Transfer assets with depressed current values.** Although stock market averages seem to be resilient to the effects of the pandemic (so far), many asset values have fallen. Gifts of assets with depressed current values may be timely, allow more significant gifts, and remove future appreciation from the later estate value. For example, a depressed stock price allows gifting of more shares within the annual gift exclusion or lifetime gift exemption.

"What if I Don't Have Enough Left?": Addressing Concerns About Loss of Access to Gifted Assets

13. **Use a spousal lifetime access trust (SLAT).** A couple of moderate wealth may be concerned about making a large transfer to take advantage of the $11.58M exemption because they would lose the benefit of the gifted assets if there was a future need. A SLAT provides some comfort: One spouse can gift assets up to the exemption amount to a SLAT which is administered for the benefit of his or her descendants, but also allows the other spouse to receive benefits if needed. This structure provides a safety net for both spouses as long as they live and stay married. SLAT assets are also typically protected from creditors of the first spouse. As the creation of the SLAT

is a completed gift, the assets, including all appreciation are generally excluded from the estate of both spouses, and pass to the ultimate beneficiaries.

Taxes Are Not the Only Consideration

The pandemic and its aftermath serve as reminders to update one's durable powers of attorney and advance health care directives. Durable powers of attorney specify who and how one's financial affairs shall be managed upon incapacity. Advance health care directives require reflection about one's wishes and values including life prolonging procedures, organ and tissue donation, and burial arrangements.

The attorneys at Hoge Fenton utilize sophisticated strategies for business owners, family offices, high net worth individuals and families. Our approach integrates complex estate planning, tax planning, and business succession planning (if appropriate). This approach helps our clients create effective estate plans that aid their loved ones and while taking advantage of often overlooked opportunities to reduce their taxes. This high-touch, holistic approach leads to effective plans that benefit our clients and their families.

Meet Our Trusted Advisors:

Heather Boshears is an experienced attorney in the firm's Estates and Trusts group. She works closely with the firm's sophisticated clients to prepare comprehensive estate plans, handle post-death administrations, and resolve disputes before reaching trial. She advises clients in tax matters including estate and gift tax and real property reassessments. Heather serves as Co-Chair of the San Mateo County Bar Association's, Estate Planning, Trust and Probate Section and has served the executive committee in roles including Chair Pro Tem 2018-2019, Treasurer 2016-2017, and Chair of New Attorneys 2013-2017. Heather is a Top Rated Estate Planning & Probate Attorney selected to Northern California Super Lawyers "Rising Stars," 2017 – 2020.

Tim Maximoff counsels his clients in estate planning and estate and trust administration, tax, business, and related matters. Tim uses his 30 years of experience to explain to help his clients reach their planning goals. Where appropriate, Tim introduces his clients to more advanced planning tools that could increase benefits to his clients and their family, help reduce the tax impacts and address his clients' concerns about asset management, preservation of assets, or beneficiaries' unique situations. Tim is a Fellow of the American College of Trust and Estate Counsel (ACTEC). He is also the past Chair of the Taxation Section of the State Bar of California and past president of the Santa Clara County Estate Planning Council. Tim has been named a "Northern California Super Lawyer" every year since 2000 and received the top "AV" rating from Martindale Hubble.

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