ROPES & GRAY

PRIVATE CLIENT GROUP

FALL NEWSLETTER

THIS HAS BEEN AN UNUSUAL YEAR, by any measure, and it is not over yet. As we head into the last quarter of 2020, there are some personal planning possibilities to consider. The Setting Every Community Up for Retirement Enhancement (SECURE) Act and the Coronavirus Aid, Relief, and Economic Security (CARES) Act are still new, and there is the prospect for more tax legislation next year. Speculation abounds, but if November produces a Democratic victory, it is fair to say that the current gift and estate tax exemption could be reduced as soon as next year, income tax rates could increase, and the preferential treatment of long-term capital gains (LTCGs) could end for some taxpayers. In addition, regardless of the outcome of this fall's election, there are opportunities to plan in the current low interest rate environment, and there are charitable giving opportunities that will disappear at the end of the year.

PLANNING FOR NEAR-TERM TAX LAW CHANGES

Using Your Gift and Estate Tax Exemption Before It Disappears

The prospect of a Biden administration in 2021 may have you wondering what changes might be in store for federal gift and estate taxes, and how you might plan for those changes. Although it is impossible to predict which reforms will be enacted and when, one likely change is a reduction in today's high gift and estate tax exemption level, and that change could come as early as next year.

Today's gift and estate tax exemption. Today, the gift and estate tax rate is 40%, and the exemption—the threshold for paying that tax—is $11,580,000 per person, or $23,160,000 for a married couple. This number is adjusted for inflation each year. The exemption can be used to shelter from tax both lifetime taxable gifts and assets held at death. Before 2018, the exemption was $5,000,000 plus an inflation adjustment from 2011, and it was doubled by the Tax Cuts and Jobs Act of 2017 to $10,000,000 plus an inflation adjustment. Under the 2017 act, the current doubled exemption is scheduled to go back to the pre-2018 level after the end of 2025.

Here today, gone tomorrow? With the prospect of the current exemption being lowered well before 2026, and potentially to less than its pre-2018 level, it is worth considering using it while it is available. Any taxable gift will use exemption. A taxable gift is a gift that does not qualify for the annual exclusion or the exclusion for direct payment of medical or educational expenses. A taxable gift could be a gift to children or others, outright or in trust. Utilizing a trust provides potential flexibility because there may be a broad range of beneficiaries, including one's spouse, current and future children and grandchildren, siblings, nieces and nephews and other extended family members, friends, and charities. Although you cannot retain control over who receives distributions, a trusted friend or professional fiduciary can have such control as trustee. A word of caution, though: Just because you may make a huge gift today to lock in the historically high gift and estate tax exemption does not mean that such a gift is a good idea. It is important to consider how much you feel comfortable giving away, and it does not make sense to give away more than that even though it may seem like a good opportunity from a tax planning perspective.

Using your "disappearing exemption." Given how large the exemption is today, you may not feel comfortable giving away anything close to the full amount. So how much do you have to give away in order for it to matter? The answer is that you have to give away at least some of the exemption that will go away after 2025 (or sooner if there is a change in the law). You might call this your "disappearing exemption." The mechanics of calculating gift and estate taxes are complex, but suffice it to say that the way to determine your available exemption in a given year (or at death) is to start with the statutory exemption amount available for that year and subtract your cumulative lifetime gifts prior to that year (or prior to your death).

Here is some simple math:

- This year the available exemption is $11,580,000 less any taxable gifts you made in prior years.
- Assume that you make a $2,000,000 taxable gift this year and that you did not make any taxable gifts in prior years. If, next year, the available exemption goes down to $5,000,000 (to pick an arbitrary possibility), your exemption next year will be just $3,000,000 after subtracting your 2020 gift. Because the available exemption came down to $5,000,000, your disappearing exemption was $6,580,000 ($11,580,000-$5,000,000), and you did not use any of it.
- As you can see, you would have to give away more than $5,000,000 this year in order to use any of your disappearing exemption. For example, a $10,000,000 gift would use $5,000,000 of your disappearing exemption, leaving $1,580,000 of unused exemption that would disappear at the end of the year.

If you are married, you also have to take into account the possibility of "gift-splitting." For gift tax reporting purposes, spouses may elect to treat gifts made by one spouse to a third party as made half by each. Here is some more math using the same assumptions as above:

- If you make a $10,000,000 gift this year and you and your spouse elect gift-splitting, then you are each treated as making a $5,000,000 gift; neither of you will have used any of your disappearing exemption, and you will have both depleted all of your combined exemption that otherwise might have been available next year.
- If, instead, you do not elect to split your gifts, you will have made a $10,000,000 gift and used $5,000,000 of your disappearing exemption; while your spouse's disappearing exemption will expire unused, your spouse's remaining exemption will not be reduced at all, and your spouse will have the full $5,000,000 available next year.

If you are interested in exploring opportunities for using some or all of your exemption this year, we would be happy to discuss the possibilities.

ANTICIPATE HIGHER INCOME TAX RATES

The decrease in the estate and gift tax exemption is not the only potential change on the horizon. The Biden campaign has indicated other tax changes could be in store, in particular increases to the current income tax rates:

- The highest bracket for taxing ordinary income could go from 37% to 39.6%.
- LTCGs, which are currently taxed at preferential rates that top out at 20%, could instead be taxed at ordinary income rates for high-income earners.
- Similarly, the corporate tax rate could be increased from 21% to 28%.

Although in most cases there is not much to be done in anticipation of these changes, there are some things to think about:

- If you are contemplating selling appreciated investments, the potential increase in LTCG tax rates could affect your timeline. In fact, by selling appreciated investments before the rate increase, you could achieve substantial income tax savings. For example, for a married couple earning $1,000,000 of LTCGs in a given year, the increase in federal income tax resulting from the rate hike could be in the range of $130,000 to $150,000. Of course, anticipating gain realization runs counter to the common advice that one should defer taxes, if possible, so that the funds that would be used to pay for those taxes may themselves be deployed to produce income. Market considerations will also affect whether it is advisable to liquidate now or later. Careful analysis of tax and non-tax factors alike is therefore crucial.
- Variable annuities and other insurance products may also be worth revisiting due to the potential increase in capital gains rates. For individuals exploring tax deferral options, the potential increase in LTCG rates could cast certain insurance products in a new, more attractive light. These products offer tax deferral, but the cost with many of them is that earnings are eventually taxed as ordinary income rather than LTCG. If, however, LTCGs are taxed at ordinary income rates, this disadvantage would disappear, and annuity and similar insurance solutions could be worth exploring for those who wish to achieve long-term income tax deferral.
- Non-U.S. individuals may wish to reevaluate the ownership structures of their U.S. investments. For example, it is common for non-U.S. individuals to hold U.S. investments via a foreign corporation, as doing so can afford estate tax protection. However, from an income tax standpoint, the proposed increase in corporate rates would make this structure less appealing, especially if the U.S. investments are expected to regularly generate income. Consequently, other types of holding structures, such as LLCs, partnerships and irrevocable trusts, may become comparatively more attractive.

For those who have the financial means to make new charitable gifts now, *the CARES Act makes cash gifts more valuable* than ever.

CONSIDER TAKING ADVANTAGE OF A ONE-TIME CHARITABLE GIVING OPPORTUNITY

As we discussed in our last newsletter, the CARES Act, enacted last March, also provides meaningful income tax benefits for gifts of cash made to qualified public charities and certain types of private foundations before the end of 2020. Under the law, taxpayers who itemize their deductions may use such gifts to offset up to 100% of their adjusted gross income—up from 60%. If you are 59.5 years old or older and itemize your deductions, this provision may provide a rare opportunity for you to accelerate IRA distributions into 2020 and use the proceeds to make a charitable gift now—when charities' need for funding is acute as a result of the pandemic—without generating any federal income tax liability. See "Charitable Giving Opportunities" in the newsletter for additional details regarding the CARES Act and this strategy.

CHARITABLE GIVING WITH RETIREMENT PLAN ASSETS

In addition to potential and impending changes to the law, Congress's recent enactment of the SECURE Act likewise produces planning opportunities.

With the passage of the SECURE Act last December, Congress curtailed the ability to stretch out payments from defined contribution plans and individual retirement accounts after the retirement account owner's death. While lifetime payouts are still available in limited situations where children or grandchildren are named as beneficiaries, in all cases the maximum period for which withdrawals may be deferred is 10 years from the retirement account owner's date of death. By limiting the ability to defer or "stretch" withdrawals from retirement accounts over several decades, Congress has correspondingly limited the extent to which the income tax resulting from such withdrawals can be deferred.

If you are charitably inclined and are a retirement account owner, naming a charitable remainder unitrust (CRUT) as the beneficiary of a retirement account upon your death may provide an appealing and tax-efficient opportunity to create a lifetime income stream for an individual beneficiary, as well as a meaningful charitable gift.

In its simplest form, a CRUT provides that an amount equal to a set percentage of the fair market value of the trust assets, determined annually, will be paid to the individual beneficiary each year during the beneficiary's life. Upon the beneficiary's death, the remaining trust property will be distributed to a charity chosen by the retirement account owner or his or her designee. More elaborate CRUT structures benefitting multiple individuals and charities may also be created if they meet IRS parameters for CRUTs.

The CRUT is itself a tax-exempt trust, while distributions to the individual beneficiary carry out taxable income to the beneficiary each year. Thus, the trustee of the CRUT can withdraw the entire retirement plan upon the account owner's death and reinvest it, without an immediate income tax liability. When distributions are made to the individual beneficiary from the CRUT, the distributions carry out the ordinary income that the withdrawal from the retirement account would otherwise have generated—just as distributions from "stretch" retirement accounts would have. Moreover, transfers to a CRUT qualify for an estate tax charitable deduction to the extent of the charitable interest in the CRUT, reducing the retirement account owner's exposure to federal and state estate taxes.

CRUTs are highly regulated trusts that must meet specific IRS requirements. We would be glad to talk with you about how a CRUT might be used in your situation to benefit your family and charities you support.

PLANNING IN A (VERY) LOW INTEREST RATE ENVIRONMENT

Historically low interest rates present yet other interesting planning opportunities to further both non-charitable and charitable goals.

Planning for Family Members

Examples of low interest rate estate planning techniques include Grantor Retained Annuity Trusts (GRATs) and sales to intentionally defective grantor trusts. The main goal of both techniques is to transfer future asset appreciation to family members in a tax-efficient way.

- **GRATs.** With a GRAT, a donor transfers assets to a trust in exchange for the right to receive annuity payments for a specified number of years. When the GRAT terminates, any remaining property is distributed to the beneficiary specified in the trust instrument. When you transfer property to a GRAT, your taxable gift is (i) the value of the property transferred to the GRAT reduced by (ii) the present value of the annuity payments you retain. This present value is calculated using a statutory interest rate. Typically, a GRAT is structured to "zero out" the taxable gift by ensuring that the value of the retained annuity payments equals the value of the property transferred to the GRAT. Of course, if the property in the GRAT appreciates at a rate higher than the statutory interest rate, upon the GRAT's termination there will be property remaining after all annuity payments have been made. This remaining property passes to the beneficiary without any gift tax consequence. The statutory interest rate is 0.40% for October 2020, which is a historic low; this means that by setting up a GRAT today you can transfer all the appreciation on the funding assets in excess of 0.40% with no gift tax cost.

- **Sales to Intentionally Defective Grantor Trusts.** Installment sales to intentionally defective grantor trusts take advantage of low interest rates in a similar way. This strategy requires that you have an existing irrevocable trust already holding some assets (or that you create and fund such a trust). You then sell assets to the trust in exchange for a promissory note bearing interest at a statutory rate. The trust pays interest on the note to you each year, and the principal is due as a balloon payment after a specified number of years. The effect of this technique is to transfer to the trust all of the appreciation in value of the assets sold to the trust in excess of the interest rate on the promissory note, without making any taxable gift to the trust. In an installment sale, the interest rate depends on the term of the promissory note, which at current levels ranges from 0.14% to 1%. Again, with interest rates as low as they are now, it takes a relatively low rate of return for this technique to transfer value free of gift tax.

GRATs and installment sales are not the only planning techniques that benefit from low interest rates. The low rates also make this a good time to refinance intra-family loans and revisit other arrangements involving promissory notes, such as loans between trusts and split-dollar insurance arrangements.

Planning for Family Members and Charity

In addition to the above, today's low interest rates also make it an opportune time to pursue so-called split-interest planning techniques. These techniques involve creating interests for both family members and charity.

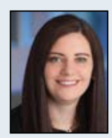
- **Charitable Lead Annuity Trusts.** If you are interested in making charitable gifts, a charitable lead annuity trust (CLAT) works especially well in a low interest rate environment. Transferring wealth to younger generations with little or no transfer tax cost, while having a philanthropic impact, is therefore more attainable than ever. A CLAT effectively operates like a GRAT, with one essential difference: The annuity payments are paid to charity. A CLAT thus pays a fixed dollar amount to one or more charitable organizations for either a term of years or a designated person's lifetime (the lead term). The payout during the lead term can be structured to replicate the donor's annual charitable giving patterns; it can also be distributed to a donor-advised fund over which the donor has advisory privileges. At the end of the lead term, the remaining trust property is distributed to one or more non-charitable beneficiaries designated in the trust instrument—often the donor's children. The present value of the non-charitable beneficiaries' remainder interest is treated as a taxable gift from the donor, which will use any available amount of the donor's lifetime federal gift tax exemption and may generate gift tax. Like a GRAT, though, a CLAT may be structured to "zero out" the taxable gift. In this scenario, the CLAT is set up so that the present value of the charitable lead interest is equal to the value of the assets used to fund the CLAT, and, therefore, the remainder interest is worth zero for gift tax purposes. The value of the charitable interest is determined using an interest rate prescribed by the IRS, with the value going up as interest rates go down. As noted above, the IRS interest rate is currently at an all-time low of 40%. This rate is available through the end of the year—even if there are market increases in interest rates. If the CLAT assets perform better than the IRS-prescribed interest rate—which is considerably more likely when the interest rate is very low—there will in fact be assets remaining in the CLAT at the end of the lead term, and they will be transferred to the remainder beneficiaries without generating any gift tax or using any gift tax exemption. A CLAT therefore offers a powerful gift-leveraging opportunity, especially in this low interest rate environment. CLATs can be structured to produce different income and transfer tax consequences to meet a donor's planning goals. We would be happy to discuss how you may best use a CLAT given your circumstances and objectives.

- **Charitable Gifts of Remainder Interests in Property.** A gift of a remainder interest in a donor's residence or farm is another charitable-giving technique that benefits from a low interest rate environment. With this strategy, a donor irrevocably transfers title to his or her personal residence or farm to a charitable organization, but retains the right to use the property for a designated period—typically the lifetime of the donor and/or the donor's spouse. Among other benefits, the donor is entitled to an immediate charitable income tax deduction, which is determined, in part, using the IRS-prescribed interest rate mentioned above. In particular, a donor's deduction increases meaningfully as the interest rate declines. With the interest rate at a historic low, such a gift therefore produces a more generous tax deduction today than ever before. A gift of a remainder interest in property is ultimately a complex transaction that implicates a variety of tax and other legal and practical considerations. While it works especially well today, it is nonetheless not the right choice for every donor or charitable organization. We would be happy to talk with you in the event you are interested in exploring whether this gift strategy could be a good fit for you.

PARTNER CONTACTS

Marc Bloostein
Partner, Boston
marc.bloostein@ropesgray.com
+1 617 951 7216

Cameron Casey
Partner, Boston
cameron.casey@ropesgray.com
+1 617 951 7987



Kimberly Cohen
Partner, Boston, New York
kimberly.cohen@ropesgray.com
+1 617 951 7082

Brenda Diana
Partner, Boston
brenda.diana@ropesgray.com
+1 617 951 7221

Jennifer Shingleton Ewing
Partner, Boston
jennifer.ewing@ropesgray.com
+1 617 951 7552

Martin Hall
Partner, Boston
martin.hall@ropesgray.com
+1 617 951 7211

Geoff Mason
Partner, Boston
geoffrey.mason@ropesgray.com
+1 617 951 7057

ROPES & GRAY

ropesgray.com

NEW YORK | WASHINGTON, D.C. | BOSTON | LONDON
CHICAGO | SAN FRANCISCO | SILICON VALLEY
HONG KONG | SEOUL | SHANGHAI | TOKYO