

To Halve or Halve Not

The Federal Estate Tax Exemption Drops in Half in 2026 (and Maybe in 2021)



Few Americans are subject to the federal estate tax, a tax on the right to transfer assets. Out of an estimated 2.7 million American deaths in 2020, only 1,900 will have estates large enough to require paying estate tax. That is because the current exemption[1] is so large — $10 million per transferor,[2] indexed for inflation since 2011.[3] For a married couple, the exemption is "portable" between them by filing certain documentation, ensuring a full $20 million combined exemption between them.

But not much longer. Under current law the unindexed $10 million exemption will drop in half to $5 million for deaths after 2025, exposing more citizens to tax. These are the "middle wealthy," whose estates are sensitive to the size of the estate tax exemption.[4]

Moreover, Congress could change the law at any time, even retroactively,[5] to reduce the exemption or to increase the tax rate. If the November election gives Democrats both the White House and control of Congress in 2021, it is quite feasible that law changes later in 2021 or even in 2022 could apply retroactively to deaths as early as Jan. 1, 2021. Be prepared for a potential flurry of planning activity this December.[6]

Because the higher exemptions are "use it or lose it," the obvious planning solution is to give away most or all[7] of the estate irrevocably during life, locking in the benefit of the higher exemption. Final "anti-clawback" regulations issued by the IRS clarify the effectiveness of that strategy.[8] However, none of my middle wealthy clients are interested in impoverishing themselves merely to save taxes upon their death.

What the middle wealthy need is a way to make a sizeable gift to an irrevocable trust with three key requirements: (1) potential later distributions back to the Grantor if needed or desirable; (2) a completed gift upon funding to utilize the higher exemption; and (3) no inclusion of the trust assets in the Grantor's estate upon death.[9] How can we do so? Let me count the ways.

1. TENNESSEE INVESTMENT SERVICES TRUST (TIST)

A Tennessee Investment Services Trust (TIST)[10] is a domestic asset protection trust (DAPT), authorized by law in 19 states, including Tennessee, and is a statutory exception to the general

rule that creditors can reach a self-settled trust. If all the requirements are met,[11] the Grantor can fund a TIST that includes himself as a discretionary beneficiary, prevents his creditors from reaching the trust assets, and creates a completed gift.

IRS rulings have been generally favorable in not including a TIST in the Grantor's estate at death.[12] Understandably, the IRS requires a review of all the facts and circumstances, but most important is the lack of any evidence of an understanding or prearrangement between the Grantor and the Trustee about distributions back to the Grantor.[13]

2. SPECIAL POWER OF APPOINTMENT TRUST (SPAT)

Instead of giving a Trustee (or Trust Protector) discretionary authority to make a distribution back to the Grantor, an irrevocable trust could be created for beneficiaries other than the Grantor, but one or more individuals who are not the Grantor (and who may or may not be a beneficiary) are given a special power of appointment to appoint trust assets among a class of individuals that happens to include the Grantor. The class must not be so narrow as to include only the Grantor, nor should the class include the powerholder.

With a Special Power of Appointment Trust (SPAT),[14] the Grantor is technically not a "beneficiary" of the trust at all and so it is not a self-settled trust.[15] Furthermore, the holder of the power of appointment [16] is not a fiduciary and may exercise broad discretion without regard to the interests of other beneficiaries of the trust, eliminating the conflicts that a Trustee has as a fiduciary with duties to all beneficiaries.[17] Again, however, there must be no evidence of any prearrangement or agreement between the Grantor and the holder of the power of appointment.

3. SPOUSAL LIFETIME ACCESS TRUST (SLAT)

A Spousal Lifetime Access Trust (SLAT)[18] is simply a "credit shelter trust" created for the Grantor's spouse's benefit during life rather than at death, creating a completed gift, avoiding inclusion in the Grantor estate at death, and making assets available to the spouse during the spouse's life, and therefore indirectly back to the Grantor. It also provides creditor protection for both the Grantor and the spouse.

If the spouse predeceases the Grantor, the spouse could exercise a limited power of appointment broad enough to appoint assets back in trust for the Grantor (perhaps only with the consent of a non-adverse third party).[19] Or a Trust Protector could be authorized to add the Grantor as a beneficiary of the trust if and when it continues beyond the spouse's death.

Broader yet is for both spouses to create SLATs for each other, ensuring trust access for both during both lives. However, such a plan would not work if the trusts are considered "reciprocal,"[20] which treats each trust as having been created by the beneficiary rather than by the alleged grantor, voiding all the desired benefits. Considerable planning is required to make them non-reciprocal.

4. GRANTOR RETAINED INCOME TRUST (GRIT)[21]

One of the three requirements discussed for an ideal trust is for such trust not to be included in the Grantor's estate at death. Prior proposed anti-clawback regulations had stated that the higher exemption would be respected for larger gifts "whether or not included in the gross estate," leading commentators to recommend that the Grantor of a trust deliberately retain an income interest without losing any of the benefit of the higher exemption at the time of the gift.[22] However, the Preamble to the final "anti-clawback" regulations suggests that the Treasury is considering adding an "anti-abuse" section for trusts that are included in the Grantor's taxable estate, perhaps limiting the Grantor's estate to only the reduced exemptions at death despite having used larger exemptions during life, a nightmare scenario.[23] This threat by the IRS has created a huge "chilling" effect on GRITs, though some advocates remain.

CONCLUSION

The "middle wealthy" in America who hope or expect to outlive the availability of currently high gift and estate tax exemptions have options to "use it before they lose it," but the options are not simple.

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NOTES

1. The gift and estate tax exemption is technically known as the Basic Exclusion Amount.

2. The gift tax and estate tax exemptions are "unified," in that gifts during life are nontaxable to the extent sheltered by the exemption, but exemption used during life reduces the amount of exemption remaining at death. Thus, the exemption for transfers during both life and death is one combined cumulative exemption.

3. For transfers in 2020, the indexed exemption is $11,580,000 per transferor, or $23,160,000 combined for a married couple. For simplicity, this column uses only the non-indexed numbers.

4. How many "middle wealthy" exist? In 2017, when the exemption was the unindexed $5 million, there were 5,500 taxable estate tax returns filed, compared to an estimated 1,900 in 2020. That suggests that if the exemption drops in half, about 3,600 additional estates per year will pay estate tax that would otherwise not be taxable. Over a decade, that means at least 36,000 additional taxable estates, or about 800 in Tennessee, whose population is a little over one-fiftieth of the U.S. population.

5. In *U.S. v. Carlton*, 512 U.S. 26 (1994), the Supreme Court upheld a retroactive repeal of an estate tax deduction. In *Quarty v. U.S.*, 170 F.3d 961 (1999), the Ninth Circuit Court of Appeals upheld a retroactive increase in the estate tax rate.

6. We have been here before. The 2012 indexed exemption of $5,120,000 was scheduled to drop to only $1 million in 2013. In December 2012, many clients made gifts in excess of $1 million in order to utilize the higher exemption while it lasted, only to see Congress the next year extend the higher exemption indefinitely, effective retroactively to Jan. 1, 2013, creating "buyer's remorse" for some. In any event, many clients in 2012 could afford to make gifts in excess of $1 million ($2 million per married couple), compared to the 2020 conundrum of needing to make gifts in excess of the indexed exemption of $5,790,000 ($11,580,000 per married couple).

7. Note that merely giving away an amount equal to the halved exemption does not help, since it is only the top half of the exemption (disappearing in 2026) that must be used now to benefit. A corollary is that married couples making gifts to use up their larger exemptions are better off using all of one spouse's larger exemption before the other spouse starts dipping into the bottom half of their exemption.

8. Final "anti-clawback" Regulations §20.2010-1(c), T.D. 9884, 84 Fed. Reg. 64995 (Nov. 26, 2019), clarify that lifetime taxable gifts using the higher exemptions prior to 2026 will successfully lock in the benefit, even if the taxpayer dies later when the exemption is much lower.

9. A trust is not necessarily required. Here are four potential non-trust solutions to avoid tax on the portion of an estate in excess of the federal exemption. (1) Add a formula to the Will that leaves to charity whatever portion of the estate would exceed the federal exemption. A surprising number of clients like this approach. (2) Buy commercial annuities on the life of the client (or the joint lives of spouses) with all assets in excess of the federal exemption. The underwriting matches the annuity payment with the health and life expectancy of the client. Such annuities guarantee income security for life but are not included in the taxable estate at death since they terminate at death. Authors Stephen Pollan and Mark Levine in their 1988 book *Die Broke* garnered attention for advocating extensive purchase of annuities for this and other reasons. (3) For clients with charitable intent, buy charitable gift annuities instead of commercial annuities. Charitable gift annuities

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are calculated without underwriting, which favors healthier clients, and also provide a charitable income tax deduction upon purchase. (4) Set up a private annuity between the client and a younger family member, which annuity terminates at client's death, leaving nothing in the estate (except annuity payments actually received). This typically works only with a client whose life expectancy is clearly shorter than the IRS mortality tables predict, who can still qualify to use those tables under IRS guidelines, and who then actually dies earlier.

10. See Sirknen, "Tennessee's Investment Services Act: A Monumental Change in Tennessee Trust Law," *Tennessee Bar Journal*, September 2007. See also Holbrook, "The TIST Test: Tennessee Competes for Trust Dollars," *Tennessee Bar Journal*, August 2007. Holbrook, "When to TIST? Here's a List," *Tennessee Bar Journal*, November 2007. Holbrook, "A Review of Domestic Asset Protection Trusts in Light of *Toni 1 Trust v. Wacker,*" *Tennessee Bar Journal,* April 2019.

11. To be a TIST any transfer to the trust must not be a fraudulent conveyance; the grantor cannot be insolvent at the time of the transfer nor rendered insolvent by the transfer; the trust must have a spendthrift clause; and the Trustee must be a Tennessee resident.

12. In IRS Private Letter Ruling 200944002, the mere retention by the Grantor of a current permissible interest, in the Trustee's discretion, did not by itself result in an incomplete gift or a retained interest at death. IRS Revenue Ruling 2004-64 agreed with the PLR and further stated that in order to prevent inclusion in the Grantor's estate at death there must not be any understanding or prearrangement between the Grantor or Trustee. It is also crucial that the TIST succeed in precluding creditors' claims, as creditor access can create inclusion in the Grantor's taxable estate at death. Although creditor protection is clear for a Tennessee resident with a Tennessee creditor, there exists a remote possibility of loss of creditor protection in some other state in which the Grantor of the TIST has a judgment creditor and whose state public policy is not to recognize any creditor protection in a self-settled trust. In such case the IRS could conceivably argue inclusion of the trust in the Grantor's taxable estate.

13. Two ideas may make a TIST safer from IRS attack. First, a TIST might provide objective standards for any distributions back to the Grantor, for example requiring occurrence of an act of independent significance, such as a spouse's death, an objective health need, or a net worth below some fixed amount. Second, a TIST could provide that the Trustee has no discretion to make distributions to the Grantor, but instead a Trust Protector under *Tenn. Code Ann.* §35-15-1201 *et seq.* is authorized to make discretionary distributions to the Grantor. The Trust Protector is a fiduciary, however, so the same requirement exists to avoid any prearrangement or understanding.

14. See O'Connor, Gans,and Blattmachr, "SPATs: A Flexible Asset Protection Alternative to DAPTs," *Estate Planning Journal* (WG&L), February 2019.

15. Of course, nothing prevents a creditor from attempting to claim that a SPAT is analogous to a self-settled trust. However, the Grantor as a potential appointee by third party exercise of a special power of appointment held in a non-fiduciary capacity does not meet the definition of "beneficiary" in *Tenn. Code Ann.* §35-15-103(5), nor does the Grantor have a "beneficial interest" as defined in *Tenn. Code Ann.* §35-15-103(4).

16. The choice of powerholder matters for income tax purposes. Under Internal Revenue Code §677(a), if the powerholder is not an adverse party (i.e., a beneficiary with a substantial beneficial interest), then the trust is generally a "grantor trust," meaning that the Grantor will be treated as the owner of the trust for income tax purposes and taxed on all the income, whether or not the Grantor actually receives any distributions. This might be desirable for some Grantors, for whom the taxes paid act as an additional tax-free gift to the beneficiaries of the trust. For Grantors who do not wish to have such income tax burden, either the powerholder must be an adverse party or else the distribution must require the consent of some other person who is an adverse party. Note that for the Grantor's protection against the powerholder's unexpected appointment of substantial assets to appointees not intended by the Grantor, any exercise of the appointment can require the consent of some other third party, such as the Grantor's attorney or other neutral party, not acting in a fiduciary capacity.

17. A SPAT is not usually also a TIST, since the Grantor does not name himself as a potential beneficiary, so it should accomplish its purposes regardless of which state laws might apply as to creditors. However, a SPAT might be designed with all the elements of a TIST other than naming the Grantor as a potential beneficiary, under a "belt and suspenders" approach, in case a creditor argues that it should be treated as a self-settled trust.

18. See Steve R. Akers, Bessemer Trust, *Estate Planning Current Developments and Hot Topic*s, December 2013 (Items 15 and 16), and December 2019 (Item 10.i.), at www.bessemertrust.com/for-professional-partners/advisor-insights.

19. A major concern would be the doctrine of relation back, which could treat the new trust created by the spouse's exercise of a power of appointment as having come from the original grantor's own assets. This could allow the IRS to claim that the original grantor had retained powers over the trust that brings the entire trust back into the grantor's taxable estate at death. There are no cases yet on this issue. *Tenn. Code Ann.* §35-15-505(f) states that a person who becomes a beneficiary as a result of the exercise of a power of appointment will not be considered the settlor of the trust. However, that statute may apply only in the context of blocking creditor's rights and may not preclude the doctrine of relation back for estate tax purposes.

20. In *U.S. v. Grace,* 395 U.S. 316 (1969), the Supreme Court held that two trusts created by spouses for each other, identical in terms, at about the same time, and of equal value, were interrelated and left the grantors in approximately the same economic position as if they had created trusts naming themselves as beneficiaries. Thus, minimizing the reciprocal trust risk necessarily requires maximizing the differences between the two SLATs, requiring careful thought both in design and in actual administration after their creation. For example, PLR 200426008 held that two quite similar trusts between spouses were not reciprocal when husband did not become a beneficiary of the wife's trust unless and until he survived more than three years after wife's death, and then only if his net worth or income fell below certain levels.

21. See Steve R. Akers, Bessemer Trust, *Estate Planning Current Developments and Hot Topics,* December 2019 (Item 10.j.), at www.bessemertrust.com/for-professional-partners/advisor-insights. See also Viehman, "Lessons Learned from 2012 – Preparing for 2025 (or Sooner)," available at TexasBarCle.com, October 2019.

22. Most commentators recommending a GRIT have suggested retaining a right to all the income of the trust for life, causing the trust to be includible in the Grantor's taxable estate under Internal Revenue Code §2036, but not any rights to principal. Under Internal Revenue Code §2702, if the trust is for the benefit of family members, and the income stream is not a fixed amount, then for gift tax purposes the taxable gift equals the entire gift to trust, despite a retained income stream. During the term of a GRIT, if the assets appreciate, the Trustee could distribute principal of the trust to other family beneficiaries to keep the value of the trust within the remaining estate tax exemption of the Grantor when the trust is included in the Grantor's estate. This seemed to provide the Grantor with both a completed gift and a direct income interest for life, like having your cake and eating it too. Some even suggested a GRIT could still accomplish the desired tax results even if "enhanced" by including additional provisions for the benefit of the Grantor, such as (1) the right to receive discretionary principal under a broad standard, so long as no such distribution took the principal below a fixed amount, and (2) a retained testamentary power of appointment over the assets at death,. This is known as an Enhanced GRIT, or E-GRIT.

23. Lynagh, "Potential Anti-Abuse Rules May Limit Use of the Temporarily Increased Gift Tax Exclusion," *Tax Management Estates, Gifts and Trusts Journal*, May 14, 2020.