



# WRMarketplace

An AALU Washington Report

The WRMarketplace is created exclusively for AALU members by experts at Baker Hostetler LLP and the AALU staff, led by **Jonathan M. Forster, Partner, Rebecca S. Manicone, Partner, and Carmela T. Montesano, Partner**. WR Marketplace #19-21 was written by **Lindsay R. DeMoss D'Andrea, Staff Attorney, and Jennifer M. Smith, Counsel**.

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**TOPIC: Year-End Planning Considerations.**

**MARKET TREND:** With the passing of each year, scheduled changes in the tax rules move closer to reality, making it important to take every opportunity now to manage the future.

**SYNOPSIS:** As 2020 approaches, year-end planning considerations for clients include: (1) making use of temporarily higher transfer tax exemptions; (2) managing market gains in 2019; (3) planning to take advantage of continued low interest rates; (4) closing life insurance transactions; and (5) monitoring developments in generational split-dollar.

**TAKEAWAYS:** Clients may wish to start “locking in” the benefits of the increased transfer tax exemptions by making lifetime gifts but should carefully consider asset selection and basis before gifting. Given recent market successes, basis considerations also play an important role in crafting year-end investment diversification strategies and making charitable donations, particularly for clients with significant low basis assets. Clients should continue to move forward with “estate freeze” plans (e.g., GRATs, intra-family loans), which benefit from the continued low rate environment, and proceed to close on life insurance purchases, particularly as pricing or product options may be impacted by delays or tied to year-end benchmarks. Finally, as cases on generational-split dollar continue to move through the Tax Court, clients with these

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arrangements should confer with advisors and develop action plans as needed to respond to any final Tax Court decision.

**1. TAKE ADVANTAGE OF TEMPORARY EXEMPTION HIKE**

The Tax Cuts and Jobs Act of 2017 (“**TCJA**”) doubles the “basic exclusion amount” from \$5 million to \$10 million for gift, estate, and generation-skipping transfer (“**GST**”) tax purposes (subject to inflation adjustments). In 2019, the basic exclusion amount is \$11.4 million (\$22.8 million per married couple) and will increase to \$11.58 million in 2020 (\$23.16 million per married couple). Absent additional legislation, however, this exemption hike will **expire on January 1, 2026**.

Federal Tax Law	2017	2018 - 2025	2026
Estate, Gift, & GST Tax Exemptions *Subject to inflation adjustment	\$5 million* 2017: \$5.49 million	\$10 million* 2019: \$11.40 million 2020: \$11.58 million	\$5 million* (as inflation-adjusted from 2010)
Tax Rate	40%	40%	40%
Unrealized Capital Gains at Passing	Basis step-up	Basis step-up	Basis step-up
Inflation Index	Consumer Price Index for All Urban Consumers (CPI-U)	“Chained” CPI-U (slower/smaller adjustments)	Chained CPI-U

These temporary changes create immediate opportunities for clients to use their increased exclusion amounts to make gifts with a relatively low risk of tax “clawback,” even if the basic exclusion amount has decreased by the time of the donor’s passing (See [WRMarketplace No. 19-01](#) discussing the proposed “anti-clawback” regulations issued by the IRS late last year). So, if the basic exclusion amount ultimately returns to \$5 million, or even less, clients should not be penalized for making lifetime gifts that maximize the current higher exclusion amount. With this in mind, clients may wish to “lock in” the benefits of the increased exemptions sooner rather than later by:

- Making larger gifts to new or existing trusts, including spousal lifetime access trusts (“**SLATs**”), irrevocable life insurance trusts (“**ILITs**”), and multi-generational dynasty trusts, which can preserve the gifted assets and appreciation thereon from future estate and GST taxes.
  - By offering lifetime benefits to the donor’s spouse, SLATs also allow the donor to indirectly benefit from the trust.
  - With an ILIT, large gifts also can minimize the administrative hassles of other funding approaches (e.g., using annual gifts), if desired.

- Implementing business succession plans for clients with closely-held family businesses, applying the increased exemption to cover gifts of business interests to desired successors.
- Transferring individually-owned life insurance policies to ILITs.
- Forgiving intra-family loans or using gifts to create side funds that can help support exit planning for existing installment sales to grantor trusts or split-dollar arrangements.
- Allocating GST tax exemption to non-GST exempt or partially GST-exempt trusts.

## **2. MANAGE SUCCESS IN THE MARKETS**

Clients looking to make lifetime gifts using increased exemption amounts should consider several factors, including significant portfolio stock gains clients may have experienced, particularly in 2019. Successful market performance creates additional considerations in the context of planning with lifetime gifts, including basis management, charitable planning, and the use of exchange funds.

**Basis Considerations.** Clients looking to make lifetime gifts must consider: (i) the loss of a basis step-up on appreciated assets given away during life; and (ii) the types of assets that should be gifted and the types of assets that would benefit most from a basis step-up in the estate.

*Basis Step-Up.* In general, the recipient of a gift takes a “carry-over” income tax basis in the gifted property. Depending on the asset, a subsequent sale or other taxable disposition of the property typically results in capital gains tax to the recipient on the difference in the property’s fair market value when sold and its original, carry-over basis. However, property received from a decedent (e.g., by bequest) receives a step-up in basis to its fair market value as of the date of the decedent’s death. An immediate sale of that property by the beneficiary would not generate capital gain, meaning more net gain to the clients’ beneficiaries.

*Impact on Asset Selection.* Because the basis step-up is so valuable, clients should consider giving high-basis assets during life and holding low-basis assets (i.e., low-basis stock, copyrights, trademarks, and oil and gas investments) until passing. For clients who are unlikely to owe estate tax – due to the combination of portability and the increased exemptions – planning for basis adjustments at death is especially important. In addition, clients with low-basis assets in existing trusts may want to review the options for modifying the trust, distributing the low-basis assets, or swapping out over- or under-performing assets.

**Annual Exclusion and Charitable Gifts.** The holiday season and the end of the year tend to inspire clients to make annual gifts to charity and family. In 2019, the gift tax annual exclusion is \$15,000 per recipient/donee. As with basis planning, the timing of

annual gifts is important; clients intending to make use of their annual exclusion must complete such gifts within the calendar year.

In terms of charitable giving, individuals need to take a more thoughtful approach, as the TCJA's substantial increase in the standard deduction (\$24,400 in 2019 for married taxpayers filing jointly) may reduce or eliminate the benefits of itemized deductions for some clients. Accordingly, clients may consider bundling charitable donations into one particular tax year to maximize their income tax charitable deduction. The timing of this donation "bundling" should be coordinated with the acceleration or delay of any other available itemized deductions into the same year to enhance the aggregate deduction amount. If clients expect to have greater income in 2019 (e.g., due to the expected receipt of bonus income or lump-sum retirement benefits), they may want to coordinate the bundling to occur this year.

Clients reluctant to commit significant donations to specific charities by year-end could consider making one large donation to a donor advised fund ("**DAF**"). The donation should qualify for the charitable deduction and allow the client to request that the DAF manager make payments from the fund over time to selected qualified charities.

From a basis-planning perspective, donating appreciated assets, such as publicly-traded stock, may turbo-charge the donation. Clients with low-basis stock can contribute the stock to charity and take an income tax charitable deduction equal to the fair market value of the stock (and *not* its basis), subject to applicable limitations. Donating the stock (rather than selling it and donating the proceeds) also eliminates recognition of the gain that generally would be triggered upon the asset's sale .

**Exchange Funds.** Given market successes in 2019, exchange funds have been garnering interest for clients with highly-appreciated concentrated stock positions. These funds, sometimes called swap funds, are vehicles for diversification, allowing a client to exchange a concentrated position for a more diversified group of holdings without triggering a realization event or taxable gain. The deferral of income tax on the exchange allows the investment to continue to appreciate without first being subject to capital gains tax. There are numerous considerations in weighing the costs and benefits of diversification through such funds. For instance, the funds may only be open to accredited investors and generally have a minimum investment period of seven years (otherwise a penalty may apply). Clients also may receive little or no dividends from the fund and may be required to pay fees associated with its management.

### **3. CONTINUE TO IMPLEMENT LOW RATE PLANNING**

Low interest rates (e.g., 7520 rates dropped from 3.4% at the end of last year to 2.0% for November and December 2019) continue to provide clients with excellent planning opportunities to use traditional "estate freeze" vehicles, including grantor retained annuity trusts ("**GRATs**"), charitable lead annuity trusts ("**CLATs**"), installment sales to grantor trusts, and intra-family loans. These approaches provide flexibility to minimize a client's estate while preserving the federal gift/estate tax exemption, either to use in other lifetime planning or to apply to estate taxes and the attainment of basis step-up at

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death. Further, the original value of transferred property is largely returned to the donor (e.g., through annuity payments in a GRAT or interest and principal payments with installment sales or loans), which can be critical for donors concerned about ensuring they have adequate funds to support their lifestyle.

**GRATs.** With a GRAT, the grantor transfers assets to an irrevocable trust, retaining a right to an annual annuity payment for a specified term. If using a zeroed-out GRAT (common), the present value of the annuity stream equals the fair market value of the assets transferred to the GRAT, so there is no taxable gift upon funding. At the end of the GRAT term, the balance of the trust property is paid to the client's family (or in further trust for their benefit). Because the IRS assumes that a GRAT will appreciate at the 7520 rate, low 7520 rates provide greater potential to generate asset appreciation above that rate, which passes to the trust's remainder beneficiaries without gift or estate tax (assuming the grantor survives the GRAT term). A GRAT's success can be enhanced by active management of the trust and its assets, for example, by delaying annual annuity payments to the grantor by up to 105 days (allowing longer growth within the trust) or using powers of substitution to swap out over- or under-performing assets to lock in gains or mitigate losses (see [WRMarketplace No. 14-08](#) for a discussion of GRATs).

**CLATs.** Similar to a GRAT, a CLAT is an irrevocable trust into which a client transfers property, but the annuity interest is gifted to a charity. The charity receives fixed annuity payments for a term of years, and at the end of the trust term, the balance of the trust property is paid to the client's family (or in further trust for their benefit). As with GRATs, the IRS assumes that the CLAT will appreciate at the 7520 rate. Thus, low 7520 rates provide charitably-inclined clients with the opportunity to make gifts to charity, and, if the CLAT appreciates at a rate above the 7520 rate, the excess appreciation passes to the non-charitable beneficiaries without gift or estate tax. If the CLAT is created as a grantor trust for income tax purposes, the client's contribution also may be eligible for a charitable income tax deduction in the year of the contribution.

**Installment Sales and Intra-Family Loans.** Intra-family loans and installment sales to grantor trusts also benefit from low interest rates, as they are tied to the applicable federal rate ("**AFR**"), which is the minimum rate a client could use to avoid deemed interest for gift and income tax purposes. Appreciation of the loaned proceeds or the assets sold in excess of the AFR is transferred to the family member or trust without gift or estate tax. Installment sales to grantor trusts also provide an effective tool for GST tax purposes, since the donor only needs to allocate GST tax exemption to an initial "seed" gift to the trust (typically 10% of the value of the assets sold), not to the total value of the assets purchased by the trust (see [WRMarketplace No. 14-13](#) for a discussion of installment sales to grantor trusts).

Note that, for life insurance acquisitions, the low rate environment also benefits the use of split-dollar ("**SD**") loans for acquiring large life insurance policies. With private SD loans, the insured, as grantor of his or her ILIT, makes interest-bearing loans to the ILIT to pay the policy premiums, typically secured by a limited collateral assignment of the

policy to the lender. Low AFRs may make these loans more attractive for insurance funding.

#### **4. CLOSE ON LIFE INSURANCE**

Clients also may benefit from closing life insurance purchases before 2020. If timely-implemented, clients may be able to apply their unused annual exclusion gifts to new ILITs. Further, increases in age and/or scheduled modifications in pricing and available product options may adversely impact policy premiums if insurance purchases are delayed (particularly if such changes are tied to year-end). Carriers also may be incentivized to help close on transactions if they are approaching their own tax year-ends.

#### **5. TRACK GSD DEVELOPMENTS**

As discussed in [WRMarketplace No. 18-26](#), cases involving economic benefit generational split-dollar arrangements (“**EB GSDs**”) continue to make their way through the Tax Court. EB GSDs typically involve a split-dollar arrangement between a parent and his ILIT to fund the trust’s purchase of life insurance on the parent’s child. For wealth transfer planning purposes, EB GSDs assume that the present value of the repayment owed to the parent for his payment of the policy premiums is subject to a significant discount upon transfer due to the extended repayment period (i.e., based on the insured child’s life).

While the Tax Court’s prior summary judgment opinions in *Est. of Cahill* and *Est. of Morrissette*<sup>1</sup> refused to uphold, as a matter of law, the applicability of a discount on the repayment right, these were only procedural rulings, not final decisions on the merits. *Cahill* subsequently settled, with the estate conceding that the full value of the GSD reimbursement was taxable in the parent’s estate. The *Morrissette* case, however, proceeded to a full trial on October 7, 2019, which may result in a final Tax Court decision on the merits. Pending a final resolution, clients with existing EB GSDs should review their arrangements and potential options with advisors, including whether the structure can/should be unwound or modified, if possible. They also should remain aware of these judicial developments and put together a plan of action that can be implemented promptly, if needed, after any final Tax Court decision.

#### **TAKE AWAYS**

Clients may wish to start “locking in” the benefits of the increased transfer tax exemptions by making lifetime gifts but should carefully consider asset selection and basis before gifting. Given recent market successes, basis considerations also play an important role in crafting year-end investment diversification strategies and making charitable donations, particularly for clients with significant low basis assets. Clients should continue to move forward with “estate freeze” plans (e.g., GRATs, intra-family loans), which benefit from the continued low rate environment, and proceed to close on life insurance purchases, particularly as pricing or product options may be impacted by delays or tied to year-end. Finally, as cases on generational-split dollar continue to

move through the Tax Court, clients with these arrangements should confer with advisors and develop action plans as needed to respond to any final Tax Court decision.

## NOTES

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<sup>1</sup> *Est. of Cahill*, TC Memo 2018-84; *Est. of Morrissette*, U.S. Tax Court Docket No. 004415-14, Order and Decision dated June 29, 2018.