Best Practices Discussion

Economic Uncertainty: A Certain Time to Reevaluate an Estate Plan

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The United States is currently experiencing a multitude of events that beg the question: "Is a recession coming?" From record high inflation to rising interest rates, the strength of the U.S. economy appears to be uncertain. In times of economic uncertainty, estate planning may be the last thing on an individual's mind. However, a robust estate plan can afford an individual significant tax savings and can provide ease of mind for the individual and his or her family members. A succession plan is an important element to an estate plan, particularly for an individual who is a closely held business owner, who owns a substantial real estate portfolio, or who owns appreciated marketable securities. The current economic uncertainty—combined with the coming reversion (to pre-Tax Cuts and Jobs Act levels at the end of 2025) of the estate and gift tax exclusion amount and the generation skipping transfer tax exclusion amount—makes now the right time to reevaluate an estate plan. This discussion describes three typical succession plan scenarios, including consideration of the plan goals and the tactics for achieving those goals.

The Sunset on the Horizon

The Tax Cuts and Jobs Act of 2017 ("TCJA") has proven to be important in enabling high net worth individuals to transfer wealth out of their estates and to future generations. Upon its passage, the TCJA essentially doubled[1] the gift and estate tax exclusion amount, also known as the "applicable exclusion amount," and the generation-skipping transfer ("GST") tax exclusion from the 2017 amount of $5,490,000[2] to $11,400,000[3] in 2018.

Absent any intervention from Congress, the provisions that increased the applicable exclusion amount and the GST exclusion amount will expire (i.e., "sunset") on December 31, 2025. That sunset provision will cause the exclusion amounts to revert to 2017 levels (adjusted for inflation) beginning in the year 2026.

The increased applicable exclusion amount and the GST tax exclusion amount under the TCJA have made it possible for high-net-worth individuals to transfer more assets out of their estates. However, these exclusion amounts have also caused other individuals to overlook the benefits of having a more robust estate plan in place.

This situation is in part due to the fact that many people do not believe that their estates are valuable enough to warrant the cost of engaging attorneys and other advisers to create an estate plan. This belief is common because these individuals consider their estates to be valued below the current exclusion amounts of $12,060,000 (for married couples, the exclusion is combined, totaling $24,120,000[4]).

Even more modest estates that are below today's current exclusion amounts should consider utiliz-

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ing the current exclusion amounts as much as possible, as any remaining exclusion amount above the 2017 level that is left unused will be lost once the exclusion amount reverts.

In 2019, the Internal Revenue Service issued final regulations that provided that individuals who do transfer assets out of their estate in an amount greater than the pre TCJA exclusion amount, even if below the current exclusion amount, will have preserved those gifts made in contemplation of the exclusion amount as of the date of transfer despite the reversion of the exclusion amount to pre TCJA levels beginning in 2026. This means that if an individual transfers assets out of his or her estate that are valued at, for instance, $7,000,000, which is well below the current $12,060,000 exclusion amount but above the pre-TCJA exclusion amount, the Service will respect the gift, even if it is more than the exclusion amount in 2026, and the taxpayer will not be taxed on the transfer that, as a result of the increased exclusion amount, was not subject to gift tax when made. This consideration has prompted many estate planners to advise their clients to "use it or lose it."

Although an individual may not have a taxable estate based on today's exclusion amounts, the types of assets that the individual owns may still justify implementing a more robust estate plan.

Reassessing before a Recession

The challenge for advisers to engage individuals in estate financial planning is particularly important during times of financial crisis or economic downturn. With inflation in the United States increasing to its highest level in nearly 40 years, and the Federal Reserve's continued efforts to raise interest rates in an attempt to curb inflation, economists and business owners are concerned that a recession may be in the not too distant future for the United States.[6]

In addition to concerns surrounding inflation and increasing interest rates, individuals see the value of their assets, particularly stocks, begin to decrease. In June of 2022, the U.S. stock market officially entered a bear market, which occurs when the stock market decreases by roughly 20 percent.[7]

Declining asset values mean that individuals may need to use certain assets that they otherwise were hoping to refrain from using. As a result, the concept of transferring assets outside of one's estate, effectively making those assets unavailable for the owner's use, may not appeal to individuals who are weary of current and future economic conditions.

Certain asset values are decreasing and interest rates are on the rise. Despite this, interest rates are still at lower levels than we had seen during the Great Recession[8] and in the late twentieth century.[9]

However, high-net-worth individuals, as well as those with assets such as closely held businesses or real estate portfolios, may be well positioned to use such an economic circumstance to pass on more wealth to future generations.

Having an estate plan in place is important, no matter the circumstances. It becomes all the more important when considering factors such as ensuring ease of mind for your loved ones, the need for a succession plan, or minimizing tax liability so heirs may benefit in the long term from the assets an individual has accumulated over his or her lifetime.

The decrease in asset values that many individuals have been faced with this year, combined with the looming reversion of the applicable exclusion amount and the GST exclusion amount to pre-TCJA levels, makes now the best time to reevaluate an estate plan and any individual needs pertaining thereto.

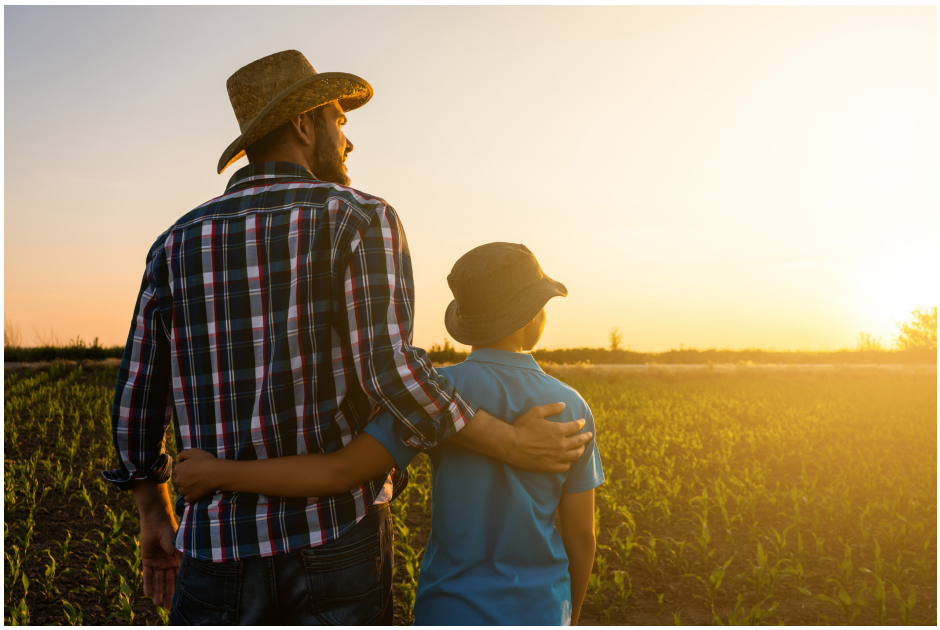
Of particular importance is ensuring that the individual has an appropriate succession plan in place with his or her estate plan. Succession planning typically involves the continued management of a closely held business after its owner/operator has retired or passed away, and it is an important element in many estate plans.

Typically, closely held business owners strive to balance family goals and continued profits when thinking about a succession plan. An additional important element of estate planning is minimizing tax exposure and liability. This goal can be accomplished through various gifting and freezing techniques, without limiting an individual's options and flexibility.

That said, a succession plan that works for the closely held business owner may not necessarily work as synchronously as a plan for the highly appreciated marketable securities owner. However, with professional guidance, it is possible to meet both tax and succession planning goals, no matter the scenario or the nation's economic outlook.

Presented below are three scenarios for tax planning and succession planning, including the

typical goals and recommended planning solutions for individuals to achieve those goals.



Scenario 1: The Closely Held Business Owner

Many times, a married couple, or perhaps one individual in the relationship, may have an ownership interest in a closely held business, such as a family farm or factory. In these instances, it is not uncommon for the owner to want his or her family members to have an active role in the business from which they can benefit in the long term.

A lasting succession plan will help preserve the family business and its long-term value. Most importantly, maintaining the flexibility to modify succession planning is important in order to address certain business variables and economic factors that are in flux—as well as any family needs that may change over time.

To ensure that the owner's business does not increase the family estate or other death tax exposure as it increases in value, freezing or gifting techniques may be utilized. Through the implementation of such techniques, the owner transfers a portion of the business interest to an irrevocable trust.

When a business owner transfers his or her interest in the business to an irrevocable trust, the business owner is transferring the asset out of his or her estate at an appreciated value. Any continued appreciation in value will be attributable to the trust rather than to the business owner had the asset passed to the owner's heirs upon his or her death.

To achieve this benefit, the business owner would first recapitalize the entity so as to create a 1 percent Class A voting membership interest and 99 percent Class B nonvoting membership interest. If the entity is a corporation, then the shareholders and board of directors should consent to recapitalize the corporation's shares into Class A voting common stock and Class B nonvoting common stock.[10]

Once the entity is recapitalized, the business owner (now, the "grantor") would gift or sell his or her Class B nonvoting interest, or stock, to a defective grantor trust ("DGT"), also known as an intentionally defective grantor trust. The grantor would retain the Class A voting membership interest or common stock so as to retain control of the entity.

A DGT is a trust in which the grantor pays the income tax on the capital gain and income associated with the assets in the trust despite the fact that the grantor has relinquished ownership of the assets by placing them in the trust.[11]

A DGT is a typical estate planning tool for a business owner who wants his or her family to benefit from the appreciation in value of the membership interest or stock. However, it may not be the right tool if the business owner does not have the funds to pay the income tax associated with income and gain on assets held in the trust. That said, the grantor may borrow funds from the business or the DGT in order to pay the tax.

Although gifting an interest to a DGT is an efficient tax planning tool, a grantor may also wish to:

1. sell a portion of his or her interest to the DGT and
2. also gift a fraction of his or her interest to the DGT.

When a grantor gifts assets out of his or her estate and into a DGT, the grantor is effectively relinquishing ownership of those assets, thus making them inaccessible for the grantor's continued use.

However, an installment sale is a good option for a grantor to whom a return on equity is still necessary during the grantor's lifetime. Additionally, a sale is more desirable as it better protects against Internal Revenue Code Section 2036(a)(2).[12] The assumption here is that the value of the sold interest will outperform the interest rate associated with the installment sale note. Over time, the grantor may forgive all or a portion of the installment note so as

to effectuate a gift to the DGT. In today's low interest rate environment, installment sales have gained in popularity among estate planners and their clients. However, the transaction must be a bona fide sale for adequate consideration.[13]

Therefore, before an installment sale may occur, the DGT should have sufficient assets in the trust in order to pay the interest on the installment sale note. As a result, a grantor typically makes a substantial gift of cash or securities, typically an amount equal to 10 percent of the value of the asset being sold, to the DGT beforehand.[14] This is known as a "seed" gift, and it ensures the trust has substantial assets besides the installment note.

A DGT is also an effective estate planning tool because, although the grantor has relinquished ownership of the assets, the grantor may retain the power to swap an asset out of the trust and substitute the asset for another asset of equal or greater value.[15]

This procedures provides some flexibility when it comes to accessing certain assets placed in trust. The substitution power further allows for effective income tax planning by providing a method to get low tax basis assets that are highly appreciated back into the grantor's estate in order to maximize the step up in basis to fair market value upon his or her death.

By either gifting or selling (or a combination of both) the Class B nonvoting membership interest, the grantor freezes the value of the gifted or sold interest at the time the grantor makes the transfer. Further, the grantor will then apply valuation discounts to value the gifted or sold interest. These valuation discounts are required to determine the fair market value of the particular asset transferred, as they factor into what a willing buyer would pay a willing seller for the asset.

When it comes to closely held businesses, the typical valuation discounts include:

1. a discount for lack of control and
2. a discount for lack of marketability.

The application of these valuation discounts is beneficial to the grantor because such discounts allow a greater transfer out of his or her estate while using less of the applicable exclusion amount and GST exemption amount.

It is important to adequately disclose the value of an asset gifted to a trust in order to:

1. remain compliant with the Service adequate disclosure requirements outlined in Treasury Regulations Section 301.6501 and
2. begin the three-year statute of limitations period that the Service has to contest a gift tax return.

Adequate disclosure allows for the three-year statute of limitations to run on a 709.

It is always recommended that a grantor obtain a professional business valuation by a qualified appraiser that takes valuation discounts into consideration. A professional business valuation may provide more leverage against an assertion from the Service that the adequate disclosure requirements were not met than otherwise would be the case had the grantor not obtained a "qualified" business valuation by a "qualified" appraiser. Contemporaneous appraisals are a deterrent to Internal Revenue Service valuation challenges and penalties.

Finally, the grantor will retain his or her Class A voting membership interest in the entity, which enables the Class A owner to retain administrative control over the entity, as well as flexibility regarding succession planning.

Scenario 2: The Real Estate Owner

Individuals who own real estate portfolios may want to (1) fairly balance the treatment of family members involved in the real estate ventures with those who are not involved, (2) avoid probate, and/or (3) ensure a step up in basis for real estate assets that the owner passes to family members.

While property values have remained strong over the past two years, in part driven by the low interest rates, we have seen in response to the COVID-19 pandemic, the probate process can tie up real estate assets for months, if not years, as well as eat into the gain realized on the sale of these assets.

Transferring property to a limited liability company ("LLC") provides probate relief, and transferring the interest in the LLC to a trust provides tax efficiencies.

Similar to the above-mentioned closely held business owner, the real estate owner may also utilize a combination of an LLC and a DGT:

1. to preserve property values and
2. to ensure such assets are easily accessible by the intended beneficiaries.

To achieve these goals, first, the real estate owner would transfer the property to a holding company, typically a single member LLC with a 1 percent Class A voting membership interest and a 99 percent Class B nonvoting membership interest.

Second, once the property is in the LLC, the owner (the grantor) would gift the Class B nonvoting membership interest to the DGT. Here, real property

appraisals, developed by a qualified appraiser, may prove useful in adequately disclosing the value of the underlying assets of the holding company.

Third, the grantor may then apply valuation discounts for the interest in the LLC that he or she gifted to the DGT, which is best determined by another appraisal.

If a return on equity is also important to the real estate holder, installment sales provide flexibility while still accomplishing a freeze in value. Further, a grantor's substitution power is typically used when real property is transferred directly to a DGT rather than held in an LLC that is then transferred to the DGT.

This procedure is in part due to the fact that the grantor can swap a piece of property with a low basis in the trust for a different piece of property, of equal or greater value, with a higher basis. If the DGT sells the asset with the higher basis, then less gain would be subject to tax than if the DGT retained the lower basis piece of property and then sold it.

The lower basis asset, which would be placed back in the grantor's estate, would then receive a stepped-up basis upon the grantor's death.[16] Still, using an LLC or partnership ownership structure allows flexibility with future highly appreciated real estate, which can be distributed to the DGT with minimal tax consequences. Then, the grantor can use his or her substitution power and swap cash, a note, or another high basis asset to the DGT in exchange for the low basis real estate. The grantor would achieve a new tax basis of fair market value at death, with all the depreciation and taxable gain benefits that may extend to future generations.

It is important to note that the holding company structure provides a level of protection for the members and assets that would otherwise be the case if the real property were transferred directly to the DGT. Thus, the holding company structure is a worthwhile consideration when dealing with property that is owned jointly by multiple family members or investors.

When dealing with a multi-member LLC that is the holder of real estate, the LLC's operating agreement can govern the disposition of a member's membership interest. This means that, in the event a member wants to sell his or her interest, the other members may have the right of first refusal to purchase the seller's membership interest.

For example, let's consider a situation where two siblings form an LLC and then contribute property they held jointly into the LLC. The siblings then each hold a 0.50 percent Class A membership interest and a 49.50 percent Class B nonvoting membership interest.

Sibling 1 takes his or her Class B nonvoting membership interest and gifts it to a DGT for the benefit of his or her children. Sibling 2 does the same with his or her interest and gifts to a DGT established for the benefit of his or her children.

The LLC now has four members, and both the siblings would like their beneficiaries' trust to have the right to acquire the other trust's membership interest, should one decide to sell.

A well-drafted operating agreement that incorporates a right of first refusal for the other members to acquire the membership interest or a buy-sell provision would accomplish the initial members' goal to keep the interest and, therefore, the property, within the family for its continued use. This provision would provide a "market" for the family assets.

The holding company structure preserves the basis increase one would expect to receive upon the death of a partner for the interest that the grantor did not transfer.

In this scenario, with an individual holding the Class A voting membership interest and a DGT holding the Class B nonvoting membership interest, the basis increase would be applicable to the grantor's retained Class A membership interest, not the DGT's Class B nonvoting membership interest.

This holding company structure also provides significant benefits when it comes to valuing the LLC, as valuation discount planning techniques may be utilized. The DGT structure itself, again, provides income tax benefits, as the income from the trust will be taxed to the grantor. With the grantor paying the tax, he or she uses up the assets that remain in the estate.

Due to these income tax benefits and these gift and estate tax benefits, real estate holding companies and DGTs are popular succession planning tools.

Scenario 3: The Owner of Highly Appreciated Marketable Securities

The owner of highly appreciated marketable securities may want family members, or more particularly a spouse, to benefit from these assets in the long term. As such, planning to ensure that family members appropriately utilize the assets is important.

Typically, most marketable securities are held in a brokerage or retirement account. However, the owner can transfer his or her brokerage account to a trust.

While stock values have decreased this year, gifting a brokerage account with depressed stock values that are highly appreciable enables the grantor to utilize less of his or her exemption amounts than

waiting to gift the brokerage account after values have appreciated.

In this scenario, an estate planner may utilize a Spousal Lifetime Access Trust ("SLAT"). SLATs can be beneficial in providing for the owner's spouse and family members.

A SLAT is an irrevocable trust. However, SLATs are unique from other kinds of trusts, such as a DGT, in that the spouse may be a beneficiary of the SLAT. Like a DGT, the income tax from the trust will be paid by the grantor.

Once the owner transfers his or her securities to the SLAT, the trustee, which is typically the spouse benefitting from the SLAT, may make distributions of income and principal to the beneficiaries (i.e., the non-grantor spouse).

Once the non-grantor spouse passes away, the remaining beneficiaries, typically children or grandchildren, will benefit from the trust by either receiving the trust assets outright or in further trust.

A SLAT has an added layer of complexity that is worthy of consideration.

First, the grantor spouse may not split gift the assets transferred to the trust, which means only the grantor spouse's exemption amounts will be utilized, rather than using both spouses' exemption amounts and treating the gift as being made one-half by each. This may be appealing in light of the exclusion amount reducing to pre-TCJA levels beginning in 2026. This is because a couple may use all of one spouse's exemption amount before 2026 while leaving the other spouse's exemption amount intact.

Second, if the non-grantor spouse is serving as both trustee and beneficiary, then the spouse must be limited in making distributions. The non-grantor spouse should only be able to make distributions in accordance with an ascertainable standard, such as health, education, maintenance, or support. Appointing a disinterested third party as trustee would enable the trustee to make discretionary distributions to the beneficiaries.

In addition, in the event each spouse establishes a SLAT in which the non-grantor spouse is a beneficiary, it is imperative the trusts do not run afoul of the reciprocal trust doctrine. Under this doctrine, the Service considers the two trusts to be so interrelated that they were established for the benefit of the grantor.

If the trusts violate the reciprocal trust doctrine, then the assets transferred to the SLAT can be pulled back into the respective grantors' estates. If a married couple is establishing two SLATs, careful planning should be implemented.

Summary and Conclusion

While uncertain economic times may seem like a deterrent to establishing a robust estate plan, such uncertainty also provides a unique opportunity to take advantage of depressed asset values. The fast approaching "sunset" of the TCJA provisions that greatly increased the applicable exclusion amount and GST tax exclusion amount creates a greater urgency to ensure individuals have fully considered and revised their estate plans as applicable.

Each individual's succession planning goals are unique to that person's facts and circumstances. To adequately achieve those goals, it is important to talk with an attorney who is knowledgable regarding the way these goals are intertwined from a tax, business, and estate planning perspective.

The contents of this discussion are presented for informational purposes only and should not be construed as legal advice.

Notes:

1. In 2011, Congress set the applicable exclusion amount at $5,000,000 and is adjusted yearly for inflation. The TCJA increased the amount to $10,000,000, adjusted for inflation.
2. IRS 2017 exclusion amount.
3. IRS 2018 exclusion amount.
4. IRS 2022 exclusion amount.
5. IRS preserve exemption, https://www.irs.gov/newsroom/treasury-irs-making-large-gifts-now-wont-harm-estates-after-2025.
6. Harriet Torry and Anthony DeBarros, "Recession Probability Soars as Inflation Rises," *Wall Street Journal* (June 19, 2022), https://www.wsj.com/articles/recession-probability-soars-as-inflation-worsens-11655631002.
7. Lewis Krauskopf, "Bear Market Confirmed as U.S. Stocks' 2022 Descent Deepens," *Reuters* (June 14, 2022, 1:00 AM), https://www.reuters.com/markets/europe/bear-market-beckons-us-stocks-2022-descent-deepens-2022-06-13/.
8. Treasury department interest rate 1981, 2008, versus now.
9. In this scenario, the entity would likely be a subchapter S corporation.
10. See 26 U.S.C. § 671.
11. See 26 U.S.C. § 2036(a)(2).
12. See 26 U.S.C. § 2036.
13. The requirements of an installment sale are beyond the scope of this discussion.
14. See 26 U.S.C. § 675(4).
15. See 26 U.S.C. § 1014.

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