TamarFink
WEALTH IMPACT

Cleaning Up Prior Estate Planning

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PRIOR ESTATE PLANNING

Due to the continuous increase in the gift, estate and generation-skipping transfer (GST) tax exemptions over the past 8 years, estate planning opportunities have never been as extensive:

- In 2019 the gift, estate and GST tax exemptions are $11.4M – up from $5.49M as recent as 2017

Clients should use the changes in gift, estate and GST tax laws as an opportunity to review and update their current estate plans. In reviewing their current estate plans, clients are likely to find opportunities to take advantage of the transfer tax laws.

In addition, as part of that review, clients may find options to "clean up" their old estate plan.

- This clean up may take the form of simplifying their existing estate plan and reducing the complexity of administration caused by their old estate plan.
- This review and clean up should extend not only to revocable trusts and Wills, but should also include previously established irrevocable trusts and the assets owned by those trusts, including insurance.

It is important for all clients to re-evaluate their estate plan, regardless of their net worth.

Recently, the gift, estate and generation-skipping transfer (GST) tax exemptions have increased to $11.4M. The increased exemptions could allow individuals to make substantial gifts and transfer assets out of their taxable estates without triggering gift taxes. This enhanced gifting capability could be used to simplify and clean up existing plans and to remove any unwanted complexity.

Following is a list of examples and explanations of some real life situations that can benefit from an estate plan clean up.

LOANS TO CHILDREN

Parents are limited in the amount they can annually gift to their children without using a portion of their lifetime gift tax exemption. This annual amount is currently $15,000 per child per year or $30,000 with gift-splitting. Any amount gifted over this annual limitations would use up a portion of their limited lifetime gift tax exemption. In the past, parents were generally hesitant to exceed this annual exclusion amount because the lifetime gift tax exemption was more limited; however, due to recent changes, the lifetime gift tax exemption has been increased to $11.4M. Prior to the change in the gift tax law, parents were generally left with one option – loan the amount exceeding the annual exclusion to their children. These loans could add complexity to their lives as they would have to properly administer the promissory notes (i.e. – track annual interest payments and loam amortization) and possibly generate income to the parents if they simply loaned the money to the child instead of grantor trust established for the benefit of the child. After many years, the cost and time involved with these loans and their administration could start to become burdensome. It is now possible for parents to use a portion of the new $11.4M gift tax exemption to unwind these past loans.

EXAMPLE

Dr. Doe's son had lost his job and needed to replace income of approximately $16,000 per month. Unfortunately, the annual exclusion amount is only $15,000 per year. Therfore, Dr. Doe loaned the difference, $177,000, to his son. Dr. Doe's son got accustomed to this "free" money and failed to look for a new job for several years. Dr. Doe now has approximately $500,000 in outstanding promissory notes from his son, all with different maturities and interest rates.

THE OPPORTUNITY

Dr. Doe can now simply forgive the notes and still use the remainder of his gift tax exemption for other planning techniques.

OTHER CONSIDERATIONS

- **Loss of Leverage:** Forgiveness of debt may not let clients leverage their gifting dollars. For example, a gift of cash to an irrevocable life insurance trust ("ILIT") could be leveraged if the gift was used to purchase life insurance. Remember, life insurance, if owned correctly, can be income tax-free and estate tax-free through the generations.
- **Equalization**

  Option 1: If not all of the children have outstanding debts, the parents' revocable trust(s) may need to be updated to provide an equalization gift to those children who did not have debt forgiven.

  Option 2: Dr. Doe could make current gifts to his other children (or to trusts for their benefit) in the amount of the loans forgiven to currently equalize the children. If $500,000 were given to each of Dr. Doe's three children (total of $1.5M), he would still have $9.9 million of lifetime gifting exemption remaining to use for other planning techniques.

NOTE: The example above relating to gifts to children and the administration of promissory notes is equally applicable to prior gifts to an ILIT to finance insurance premiums. Rather than continue to incur the cost and time of administering several promissory notes, the grantor of an ILIT, which has previously financed insurance premiums through loans to the ILIT, may forgive the existing notes (or make a cash gift to the ILIT that allows the ILIT to repay the notes).

BAD IDIT BAILOUT

A person's lifestyle or family dynamic can change considerably within just a few years. For many, the provisions set forth in an existing intentionally defective irrevocable trust ("IDIT") can become outdated or lose relevance with changing circumstances; or a person may just change his or her mind. Because IDITs are irrevocable, it is not possible to amend the provisions of an IDIT to reflect current situations. Therefore, it may be beneficial to create a new IDIT with provisions that are more consistent with a client's current desires; however, a fundamental problem exists – how does a client get the assets from the old IDIT into the new IDIT?

EXAMPLE

Mr. Smith created an IDIT (the "Old IDIT") several years ago when his children were much younger. Mr. Smith initially gifted assets to the Old IDIT and later sold assets to the Old IDIT in exchange for a

promissory note. The Old IDIT required mandatory income distributions to begin when his children reached age 21 and required the trust to terminate and distribute all assets when his children reached age 35. Mr. Smith now realizes (after speaking to his estate planning attorney) that outright distributions rarely make sense, because the assets could become subject to the claims of his children's creditors or ex-spouses. Mr. Smith would like to replace the Old IDIT with a new IDIT (the "New IDIT") that keeps the assets in lifetime trusts.

THE OPPORTUNITY

Mr. Smith can create the New IDIT and contribute the promissory note owed to him from the Old IDIT to the New IDIT. The Old IDIT can repay the promissory note by transferring assets to the New IDIT.

OTHER CONSIDERATIONS

- **Special Trustee Amendment:** Although IDITs are irrevocable, the grantor may have appointed a Special Trustee who has the power to amend provisions of the trust agreement to account for changes in the grantor's family situation or to carry out the general intent of the grantor in creating the trust (i.e. – update certain tax-related provisions). The Special Trustee may want to consider whether it is appropriate to exercise this power instead of creating a brand new trust.
- **Valuation:** An appraisal may be required if the Old IDIT owns hard to value assets such as an interest in a closely held business or family limited partnership.

NOTE: The example above relating to a bailout of an old IDIT would also apply to the bailout of and OLD ILIT. As part of the review of the existing provisions of an old ILIT, the insurance owned by the ILIT should be examined to confirm whether it is still a competitive product, sufficient in coverage, etc.

CHILDREN'S HOUSES

Some parents enjoy helping their children buy a home or simply purchase homes for their children. Often times they will also continue to pay the costs to maintain the homes for the children as well. Parents rarely like to charge their children rent to live in these homes, and may inadvertently be making a gift to the child if the fair market value rent for such a home exceeds the parents' annual exclusion gifts (or if they are using the annual exclusion gifts elsewhere – to fund an ILIT, for example). Parents now have the ability to make gifts of a home to a new irrevocable trust for the benefit of the child. Future appreciation of the home should be outside of both the parents' and children's taxable estates. Furthermore, the home should be protected from the child's creditors or claims of a spouse if they were to get divorced in the future.

EXAMPLE

Over the years, Ms. Jones has purchased homes for her three children. Ms. Jones has never charged her children rent, but has claimed the rent-free use of the homes on her annual gift tax return. Ms. Jones would like to transfer ownership of the homes to her children and would like them to begin paying for the homes.

THE OPPORTUNITY

Ms. Jones can create separate irrevocable trusts for each child and gift the respective homes to the

children's trusts. The trustee of each trust could then collect rent from the child for use of the home.

OTHER CONSIDERATIONS

- **Taxable Gift:** The transferring of the house to the child constitutes a gift that could require the use of a large portion of the parents' lifetime gift tax exemptions (currently $11.4M each). The parents could instead sell the house to the trust in exchange for a promissory note (disregarding capital gains taxes that could be due as a result).
- **Marital Discord:** If a child has been paying rent with his or her spouse, a gift to an irrevocable trust may be a source of contention for the child and the spouse and an outright gift could be considered.

PLANNING CONSIDERATIONS

In general, due to the changing estate and gift tax laws, it is important to review any prior estate plan in case it is outdated or conflicting with your ultimate estate planning goals.

Creating trusts and transferring assets involves complex financial, legal, tax, and other considerations. You should consult with your tax and legal counsel before proceeding.

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