Estate planning now?
In the midst of New England’s restrictions on doing business and the extreme financial market volatility, coupled with the probability that a recession may be underway, this might seem like an odd time to think about estate planning. However, assuming that the economy can recover in the short to medium term, this is actually a great moment for certain estate planning strategies. That is the first topic for this issue of Trusted Insights.

Do “the rich” flee states when taxes are raised on them? This is a tricky political question that has bedeviled Northeastern states for many years. Our second item reports on a nonpartisan examination of the question that was conducted by the National Bureau of Economic Research. (Spoiler alert: The answer is “yes.”)

We hope that this issue of our newsletter finds you well, as we all work together to bring this pandemic under control. We remain an available resource for you and your clients.

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Estate planning during market turmoil
It is a truism that no one has a “patriotic duty” to pay more in taxes than is legally required. One aim in estate planning has long been to bring death tax duties as low as legally possible. As the coronavirus pandemic unfolds, motivations may change. There may be some who are much more worried about conserving capital than speculative future taxes. Others may decide that higher taxes at death really aren’t bad enough to justify current irrevocable wealth management actions.

For those who continue to be interested in minimizing the cost of keeping wealth in the family, some unique opportunities are now presented.

Temporary low asset values
The currently enlarged exemption from federal estate and gift taxes is set to expire in 2026. Many estate planners have recommended consideration of large lifetime gifts to “lock in” the larger exemption. Given the scope of new federal debt being accumulated, the chances of an extension of the larger exemption may be diminished, giving the lock-in strategies new urgency.

At today’s lower prices, more assets may be transferred via gift before breaching the taxable threshold. It’s not just publicly traded stocks that are down in price. Nonmarketable securities, the value of family businesses, and real estate are down similar percentages, according to estate planner Alan Gassman, as reported in Tax Notes. For those who have been contemplating major gifts within the family, this may prove an opportune moment to pull the trigger.

Roth IRA conversions. One response to the loss of the stretch IRA this year has been the recommendation to convert retirement assets to Roth IRAs. The immediate tax cost of such a conversion can be hard to swallow. Today’s lower asset values mean lower taxes for conversions now. Should prices...
recover after the pandemic recedes, all that gain will be tax free.

**Low interest rates**

Several estate planning strategies rely upon the “Section 7520” interest rate in determining taxable values of transfers. As the Federal Reserve has lowered interest rates to help the economy, the 7520 rate has fallen, standing at 1.2% for April 2020 (it was 2.2% in February). Lower interest rates improve the math for some strategies, especially when coupled with reduced asset values.

**GRATs.** In a grantor-retained annuity trust, the grantor is paid a fixed dollar amount for a term of years. If the grantor survives the term, assets pass to the remainder beneficiaries and won’t be included in the grantor’s taxable estate. The GRAT is a useful tool for transferring asset appreciation in excess of the 7520 rate without further transfer taxation.

**Asset freezes.** A grantor may sell an asset to an intentionally defective grantor trust in exchange for a note. If the note equals the value of the asset, there will be no gift tax, it will be a sale for full consideration. The interest rate on the note should match IRS guidelines—for April 2020, the mid-term interest rate is 1.9%. The note will be included in the grantor’s estate, but asset appreciation in the trust assets will pass without further transfer tax, freezing the taxable value. The grantor will owe tax on the trust taxable income, which may further deplete the taxable estate.

Whether clients will be receptive to exploring estate planning ideas at this time will have to be handled on a case-by-case basis.

**How the rich respond to incentives**

Do the rich really change domiciles in order to save taxes? Intuitively, one would think that taxes are a factor in choosing a state of residence, though perhaps not the most important one. Whenever the issue of increasing taxes in many Northeastern states comes before the legislature, the potential of chasing the wealthy out of the state is raised, but there has been little more than anecdotal evidence to support the argument. The question of taxes and mobility has been studied more rigorously and dispassionately by economists at the National Bureau of Economic Research (NBER).

A bit of background is in order. For decades the federal government allowed a credit for state death taxes in the determination of federal estate tax obligations. This was a dollar-for-dollar credit, subject to a cap at 16%. The practical effect of this structure was that every state imposed an estate tax at least equal to the amount of the allowable federal credit. Should any state not have an estate tax, their citizens would be no better off, as the IRS would keep the money that the state left on the table.

That structure was changed in 2001, when the credit was converted to a deduction for state death taxes. The nominal reason for the change was to offset the costs of tax benefits enacted in the same legislation. But the effect was that states that repealed their inheritance and/or estate taxes would provide a real tax benefit to their residents. Federalism allows the states to be diverse policy laboratories. A few states killed their death taxes, then many more followed, until today only 12 states impose taxes related to death time transfers. (Many of the Northeastern states kept an estate tax and Connecticut is the last state that still imposes a gift tax.)

The NBER researchers wanted to know how billionaires responded to this new incentive to relocate to an estate tax-free state. They used the Forbes 400 list to track that movement. The basic results were not surprising:

- The number of billionaires in states with estate taxes fell by 35% between 2001 and 2017.
In the history of the U.S. estate tax, the amount exempt from the tax has never been reduced. Rather, the threshold of taxation has been increased from time to time, so as to keep targeting the federal estate tax on only the largest estates. However, the exemption is slated to fall roughly in half in 2026 under current law. That has led some estate planners to recommend making large taxable gifts before 2026, so as to “lock in” the larger exemption amount. In November the IRS issued Final Regulations that showed how this strategy will work [IR-2019-189, T.D. 9884].

Basic example. Elizabeth made a $5 million taxable gift in 2018, and so used up that much of her basic exempt amount. If she dies in 2020, her basic estate tax exemption will be reduced by that $5 million, and the remaining unused exemption will be $6.58 million. If she dies in 2026, assuming that the exemption has then fallen to $6.8 million, her basic exclusion amount will be just $1.8 million.

Larger gift. Now assume Elizabeth makes $10 million worth of taxable gifts in 2020 and survives to 2026, when the exemption has fallen to $6.8 million. The estate tax is determined by bringing taxable gifts back into the calculation and allowing whatever credits were granted for those lifetime gifts. That means Elizabeth’s basic exclusion amount in 2026 will be $10 million, even though under the statute it will have fallen much lower for anyone who made no taxable gifts at all. There is no “clawback” of the larger exempt amount, as some planners had feared might happen.

Married couple. When Fred died in 2019, his executor elected to have Ethel inherit his unused exemption amount (the DSUE), then $11.4 million. If Ethel dies in 2020, she has her own exempt amount of $11.58 million, plus the exemption she inherited from Fred, for a total basic exempt amount of $22.98 million. What happens if Ethel survives until 2026? The exempt amount inherited from Fred does not change, but her own exemption will fall. Assuming that it’s then $6.8 million, her basic exempt amount would be $18.2 million. Again, there is no clawback of Fred’s larger exemption.

Under the Regulations, one cannot use the “bonus” exempt amount first, to save the basic exempt amount for the future. In the basic example above, Elizabeth cannot try to shield a $5 million gift with the enhanced portion of her basic exempt amount. She must exhaust the basic amount before the bonus is tapped, under the ordering rules. In short, the IRS has made it explicit that, as it stands today, the extra protection from the federal transfer tax provided by TCJA 2017 is a “use it or lose it” proposition.
Briefly noted
Elective share permitted whether deceased spouse is testate or intestate

In July 2012, Kandi and her three sisters inherited certain property, including a home. Each held a one-fourth interest as a tenant in common with the rest. Kandi married Tyson Hall in May 2013. After the wedding Kandi bought out her sisters, who conveyed their interests to Kandi and her adult daughter from an earlier marriage, Brianna, as joint tenants and not tenants in common.

Kandi died intestate in 2018, and Tyson was appointed personal representative of her estate. He claimed the spousal elective share of her estate and further alleged that the deed conveying a property interest to Brianna was void because he had not joined in it as required for homestead conveyance. The lower court agreed. The Supreme Court of North Dakota now reverses in part. The Court agrees with Tyson that he is entitled to an elective share whether or not a will has been made, rejecting Brianna’s contention that the law of intestate distribution should be sufficient. However, the deed to Brianna was not entirely void, as Tyson’s participation was not required for the transfers to her from her aunts. She owns a three-fourths interest in the property [Estate of Hall, 931 N.W.2d 482 (2019)].

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