Steve Leimberg's Estate Planning
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Subject: Joan Crain & Justin T. Miller: Stepping Away from the Step-Up in Basis at Death, A Global Perspective

"There is a global precedent for the removal of an estate tax, and residents of other regions with carryover basis still benefit and require estate planning services. Canada serves as one example of what the proposed tax reform may look like in the U.S., which could mean the implementation of a new capital gains tax at death concurrently with the elimination of the estate tax. The uncertainty regarding the future of tax law in the U.S. upholds the need for careful planning, guidance and flexibility within the estate plans of wealthy Americans.

Furthermore, the need for wealth planning extends beyond the tax considerations. This is also evident from looking at global trends, as well as longstanding concerns in the U.S. regarding asset management and protection, succession planning and other legal issues. Given all the potential changes, it is important for clients and their families to work with a collaborative team of advisors who can serve the evolving multi-generational tax, estate, philanthropic and wealth planning needs."

We close the week with commentary from **Joan Crain** and **Justin T. Miller** that examines the impact of the elimination of basis step-up as well as estate tax reform.

Joan K. Crain, CFP®, CTFA, TEP is a global wealth strategist for **BNY Mellon Wealth Management**. Joan works closely with wealthy families and their advisors to provide comprehensive wealth planning. Joan joined the firm in 2001 and has more than 25 years of experience working with large multi-generational families. She specializes in multinational planning, business succession, family governance and philanthropy, and she is frequently invited to speak to clients and professional groups such as the American Bar Association, the American Institute of CPAs, STEP and numerous estate planning councils and forums throughout the United States, Canada, the Middle East and Asia. Joan received a master of business administration from Rollins College, a bachelor of education from Queens University, and a bachelor of music from McGill University. She is a Certified Financial Planner™ professional and has earned the designations of Certified Trust and Financial Advisor and Trust and Estate Practitioner. Joan is past chair of the Board of Directors of the Community Foundation of Broward and serves on the Executive Committee of the Florida Bankers Trust Division. She was named Industry Thought Leader by Global Finance magazine.

Justin T. Miller, J.D., LL.M., TEP, AEP®, CFP® is a national wealth strategist and thought leader at **BNY Mellon**. Justin works collaboratively with other advisors to provide comprehensive wealth planning advice to clients and their families. He also is an adjunct professor at Golden Gate University School of Law, a Fellow of The American College of Trust and Estate Counsel (ACTEC), and a sought-after speaker on tax, estate planning and family governance topics for leading conferences throughout the country, including events hosted by the AAML, ABA, ACTEC, CalCPA, Santa Clara University, Stanford University, State Bars of California, Georgia, Nevada, Texas and Washington, STEP, UCLA, University of Notre Dame, USC, Vistage International, and YPO. Justin has served as an executive committee member of the State Bar of California Taxation Section, an executive committee member of the Los Angeles County Bar Association Taxation Section, the chair of the Century City Bar Association Taxation Section, various leadership roles with the American Bar Association Real Property, Trust and Estate Law Section, and the editor-in-chief of the *California Tax Lawyer*. Prior to joining BNY Mellon, he was an attorney at a major law firm, where he advised wealthy families, senior corporate executives and closely-held business owners regarding tax-efficient estate and business succession planning, trust law and management and asset preservation. Justin received a master of laws in taxation and a juris doctor from New York University School of Law and a bachelor's degree, with honors, from the University of California at Berkeley.[i]

Here is their commentary:

EXECUTIVE SUMMARY:

There is a global precedent for the removal of an estate tax, and residents of other regions with carryover basis still benefit and require estate planning services. Canada serves as one example of what the proposed tax reform may look like in the U.S., which could mean the implementation of a new capital gains tax at death concurrently with the elimination of the estate tax. The uncertainty regarding the future of tax law in the U.S. upholds the need for careful planning, guidance and flexibility within the estate plans of wealthy Americans.

Furthermore, the need for wealth planning extends beyond the tax considerations. This is also evident from looking at global trends, as well as longstanding concerns in the U.S. regarding asset management and protection, succession planning and other legal issues. Given all the potential changes, it is important for clients and their families to work with a collaborative team of advisors who can serve the evolving multi-generational tax, estate, philanthropic and wealth planning needs.

COMMENT:

When it comes to tax policy, former President Barak Obama, current President Donald Trump, and former Vice President and current Democratic presidential candidate Joe Biden all have one thing in common—they all have proposed eliminating the automatic step-up in basis at death in the United States.

A step-up in basis is the readjustment of the value of an appreciated asset for tax purposes to the higher fair market value of the asset as of the date of death—or six months after the date of death if the alternate date is elected for estate tax purposes. That means the person inheriting the property gets to use a new higher tax basis for determining future capital gains if and when selling the property. In other words, any potential capital gains tax on the growth in value of assets during the decedent's lifetime would disappear for tax purposes at death—so the inheritor can sell the inherited property completely free of taxes.[ii] The new tax basis also is used to calculate future amortization and depreciation—even if the property, such as real estate, already had been fully depreciated by the decedent prior to death.

As an example, John and Jane Smith paid $5 million for an apartment building thirty years ago.[iii] When they both passed away on June 1, 2020, they already had received the benefit of $4.5 million in depreciation deductions to offset the taxation of rental income during their lifetimes. On the date of their death, the property was worth $20 million. If John and Jane had sold the property the day before they died, they would have owed federal income taxes at a 28.8% rate (25% plus the 3.8% net investment income tax) on $4.5 million—as recapture of their previous depreciation deductions—and long-term capital gains taxes at a 23.8% rate (20% plus the 3.8% net investment tax) on the $15 million of appreciation. Depending on their state of residence, John and Jane also may have owed state income taxes on the sale of the property during their lifetime—for example, up to a 13.3% state income tax in California. On the other hand, if their son Johnny inherits the property after their death, he receives a new $20 million tax basis equal to the fair market value and can re-depreciate the property based on the new $20 million tax basis to offset future rental income, even though his parents already had fully depreciated the property. Alternatively, Johnny could sell the property for the $20 million fair market value and pay zero income taxes. Moreover, since the total value of assets inherited from the parents is less than the current $23.16 million lifetime exemption amount per couple (in 2020), there also would be zero gift, estate or generation skipping transfer (GST) tax owed after their deaths.

Historically, there was a good policy reason for the step-up in basis at death—it was hard to find records of what somebody paid for an asset in the early 1900s in order to determine its cost basis, especially when certain assets could have been owned by a decedent for dozens of years prior to death. However, with the invention of computers, improved electronic storage, and better record-keeping practices over the past several decades, a step-up in basis is no longer needed for the same practical reasons.

What We May See in the Next Administration

An elimination of the step-up in basis would mean that family members and loved ones could no longer avoid capital gains taxation on inherited appreciated property. Given tax proposals from Obama, Trump and Biden, such a change seems more likely now than ever. The major difference in tax proposals is that past Republican tax proposals also have called for the repeal of the estate tax, which means there also could be changes to the

GST tax and gift tax rules. Before making any drastic changes to estate plans, it is important to be aware that a new capital gains tax regime could be created as a replacement for the estate tax—or in addition to the estate tax.

There have been similar efforts in the past to repeal or eliminate step-up in basis. The Tax Reform Act of 1976 would have required carryover basis on all inherited assets, but the provision was repealed before it took effect. In addition, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) temporarily repealed the estate tax and limited step-up in basis to $1.3 million plus an additional $3 million for surviving spouses. However, the EGTRRA estate tax repeal and carryover basis rules only applied for one year—2010. Under EGTRRA, estates also had the option to keep the step-up in basis and pay an estate tax instead, which could have been a more efficient solution for estates with highly appreciated assets.

While the elimination of the step-up in basis certainly is a possible change in the future, it is unclear whether it will take one of the following three forms:

1. Elimination of the step-up in basis without an immediate tax at death—that is, a carryover basis—while maintaining our current gift, estate and GST tax system;

2. Elimination of the step-up up in basis with an immediate capital gains tax on the unrealized appreciation at the time of death as a replacement for our current gift, estate and GST tax system; or

3. Elimination of the step-up up in basis with an immediate capital gains tax on the unrealized appreciation at the time of death while maintaining our current gift, estate and GST tax system.

In the first scenario, the current step-up in basis rules could be eliminated and replaced with a carryover basis. Such a policy would be similar to the carryover basis rules that currently apply when someone makes a gift during life. Beneficiaries would be required to take the same basis in the inherited assets that the decedent had. That would result in the beneficiaries paying capital gains tax on the previously untaxed appreciation only after they sell the inherited assets.

In the second scenario, a change to an immediate capital gains tax at death could serve as a replacement for the current gift, estate and GST tax system. The second scenario would be to adopt the deemed disposition at death (as in Canada), resulting in an immediate capital gains tax at death on all previously untaxed appreciation. Put in a global context, the elimination of the estate tax is not a new concept. Canada, in particular, serves as one example of what Americans may expect. The proposed format of shifting to a capital gains tax at death may even offer benefits to the U.S. economy as a whole, as well as wealthy families affected by this change.

There also could be a third scenario, whereby a capital gains tax would be assessed on embedded gains immediately at death, and an increase in estate tax, through a lower exemption and/or higher estate tax rates. Beneficiaries would continue to receive assets with a stepped-up basis similar to the current rules, but only after the decedent's estate pays all the necessary capital gains taxes. However, this appears unlikely to be supported by even the most ardent proponents of tax reform.

Depending on the result of elections in November 2020, with a Democratic President and a Democratic majority in both the Senate and House, not only could the step-up in basis be changed to a carryover basis, but the current exemption amount for estate and gift tax purposes could be substantially reduced from the current $11.58 million (in 2020) exemption amount per person and the tax rate for estate and gift tax purposes could be significantly increased from the current rate of 40% (in 2020). For comparison purposes, it is important to note that the exemption amount per person was only $675,000 in 2000, and estate and gift tax rates were 55%-77% for the 70-year period prior to 2001.

Regardless of the end result of this proposed tax reform, it will not eliminate the need for wealth planning. The focus and structure of estate planning may shift, depending on the various scenarios that may unfold, but wealth planning extends beyond the estate tax. Maintaining flexibility in estate plans and continuing to rely on trusted advisors will be integral to navigating uncertainties and accommodating any potential changes that lie ahead over the next several years. There are a multitude of possible scenarios and exceptions for the ways that a capital gains tax at death could be implemented and applied. For example:

- The rule could apply to all assets owned at death, which could include assets owned by a grantor trust that typically would not have been included for estate tax purposes.[iv]

- It is likely that there would be an exception for assets left to charity or a surviving spouse, which could require the spouse to take a carryover basis.

- There also could be an exception for certain small family-owned businesses and farms, which could require either a carryover basis or a deferred liability to be paid via installments, similar to our current rules for paying estate tax in installments over a 14-year period.[v]

It also is possible that a certain amount of appreciation would be exempt from capital gains taxes at death. For instance, the Obama administration proposed repealing the step-up in basis subject to several exceptions, including an exemption for the first $100,000 in unrealized gains (or $200,000 per couple). Trump's tax proposal prior to his election in 2016 mentioned an exemption of $10 million from capital gains tax at death; however, it is not clear whether the exemption was intended to apply to married couples (with a $5 million exemption per person), which would be somewhat similar to our current exemptions for estate tax purposes. Additionally, it is unclear if Trump's proposed exemption would apply to the full fair market value of the assets or only the previously untaxed appreciation. Even if there is a multimillion-dollar exemption amount, beneficiaries receiving those assets may be required to keep a carryover basis so that a future sale by the beneficiary would subject the assets to capital gains tax. On the other hand, legislation could provide that the exempt assets receive a stepped-up basis, eliminating capital gains tax on the previous appreciation of the assets.

Comparing the Different Tax Scenarios

Amy and Bob Jones have worked hard creating ABC Company and are curious how the potential changes in the estate tax may impact their wealth at death. They currently have a $10 million diversified investment portfolio with a $5 million basis, a $2 million home with a $2 million basis, and a concentrated position in ABC Company worth $13 million with a $0 basis. They have two children, Charlotte and Chad, who will inherit all the assets after Amy and Bob's death.

After the death of both Amy and Bob they would have the following tax liabilities under current law and three of the potential replacement tax systems:

	Current Estate Tax w/ $23.16M Exemption (40%)	**Carryover Basis w/ No Estate Tax (23.8%)**	**Capital Gains Tax at Death (23.8%)**	**Capital Gains Tax at Death w/ $10M Exemption (23.8%)**
Taxes Paid at Death	$736,000	$0	$4,284,000	$1,904,000
Future Tax on Unrealized Gain	$0	$4,284,000	$0	$2,380,000
Current & Future Taxes	$736,000	$4,284,000	$4,284,000	$4,284,000

The Potential Impact of Estate Tax Repeal

Because of the high estate tax exemption amounts ($11.58 million per individual and $23.16 million per married couple in 2020), a repeal of the estate tax would benefit only the estates of the wealthiest Americans. According to the Joint Committee on Taxation (JCT) and the U.S. Office of Management and Budget, less than 0.1% of Americans will owe any estate tax and the total revenue from the estate tax is less than 1% of total federal revenue. According to the JCT, the cost of increasing the estate tax exemption under the Tax Cuts and Jobs Act of 2017 is estimated to be more than $80 billion over ten years. And, according to the JCT and the Congressional Budget Office (CBO), a complete repeal of the estate tax could mean the loss of hundreds of billions in revenue over the next decade, especially when taking into account the additional interest on the national debt.

Given the impact that a repeal of the estate tax could have on the federal debt — and the federal deficits that increase the debt — part of the political negotiation process will be to identify a new revenue source. A change of this kind is not without precedent. There’s an emerging global trend away from estate taxation, and the experiences of countries that have already made the transition can provide some insight into where things may be headed in the U.S.

A Global Trend

Globally, estate taxes are becoming less significant. The costs of administration are high relative to the revenue generated by the estate tax programs, and leaders in many jurisdictions believe there are more effective ways to address potential concentrations of wealth. A number of regions with historically high concentrations of wealth, such as Saudi Arabia, Dubai, the Cayman Islands and Hong Kong, do not have an estate tax. Periodic attempts to institute an estate tax in China have also failed.[vi]

Fifteen countries in the Organisation for Economic Cooperation and Development (OECD) currently have no estate or inheritance taxes, thirty-four have no such taxes on funds inherited by lineal descendants, and most of those which do have these taxes have much lower rates than the U.S., which has the fourth highest rates in the OECD.[vii] Over the past several decades, many countries that previously had estate and inheritance taxes have abolished them, including 11 countries and two jurisdictions in the OECD.[viii]

These terminations have caused some concern over the effect on financial inequality, as well as the loss of revenue. However, so far the arguments supporting estate taxes do not outweigh their administrative costs and the lack of significant revenue derived from them.[ix]

When eliminating estate taxes, countries typically take one of three approaches:

1. Take no further action. A few jurisdictions that generally have low taxes anyway, such as Hong Kong and Singapore, abolished the estate tax without seeking any compensating capital gains tax or income tax.

2. Implement a carryover basis regime. The majority adopt an alternative that was temporarily offered in the U.S. in 2010, in which there is no step-up in the cost basis of the decedent's assets at death.Beneficiaries inherit the cost basis along with the assets, and will pay capital gains tax when they sell the assets.[x] The rationale

behind this is based on the belief that the purpose of a stepped up basis is to prevent double taxation on assets that are also subject to an estate or inheritance tax. This appears to be a common view, since countries that still have an estate or inheritance tax typically do not have a carryover basis.[xi]

3. Adopt the "deemed disposition at death" regime. A minority implement this option, under which capital gains tax is assessed on the increase in market value over cost basis of the decedent's assets before they pass to the heirs. This approach has been proposed by former President Obama, President Trump, and presidential candidate Biden for implementation in the U.S. Australia briefly tried this in 1979 when abolishing the estate tax, but reverted to carryover basis in 1985. Canada is the poster child for this approach, having had it in place since the end of the Canadian estate tax in December 1971.

There are also a few jurisdictions that apply another sort of tax to at least partially offset the loss of revenue from the absence of an estate tax. Some, such as Portugal[xii] and Bermuda, adopt a form of transfer tax such as stamp duty. This is particularly common with transfers of real property, and can be seen even when there is also an estate tax.

And finally, a very few tax inheritances and gifts as income for the recipients, in some cases with uncertainty regarding the cost basis in the hands of the beneficiaries.[xiii]

When considering the global precedent and the options outlined above, it seems most likely that the U.S. will choose either the second or third approach. To understand the details of adopting the deemed disposition at death, we take a closer look at Canada.

The Canadian Experience: Capital Gains Tax at Death

As of January 1, 1972, Canada replaced the federal estate and gift tax with a capital gains tax linked to an all-encompassing income tax regime, and the 10 provinces and two territories soon followed suit. In its place, the Income Tax Act (ITA) provides for a "deemed disposition" of capital property at the time of a gift or death. The Canadian Revenue Agency (CRA), which is the Canadian equivalent of the Internal Revenue Service

(IRS), considers the donor or decedent to have disposed of all his or her capital property immediately before gifting or dying, and to have received the “deemed proceeds.”[xiv] If the proceeds are greater (or less than) the decedent’s cost basis, a tax is assessed on the capital gain (or loss). The donor or executor is responsible for reporting the gain (or loss) on the appropriate income tax return and, in the case of a gain, paying the tax before the proceeds pass to the recipients. A net capital loss also flows through to the income tax return in the same way it would have been done, had it been realized before the deemed disposition.

In Canada, capital gains incurred in a given year are taxed at the same rate as the owner’s ordinary income that year. However, the seemingly high rate is offset by assessing the tax on just a portion of the capital gains. Currently, 50% of a taxpayer’s total capital gains in a given year are subject to tax.

Current federal income tax rates in Canada for ordinary income range from 15% (income less than $45,500) to 33% (income greater than $214,000). In addition, the Canadian provinces and territories all levy significant taxes. For instance, taxpayers in Ontario pay an additional 13.16% on all income greater than $220,000; in New Brunswick, those with income greater than $158,000 are assessed an extra 20.3%. Quebec residents are subject to a 25.75% tax on income >$106,555. As a result, the total tax rates for Canadian residents earning more than $250,000 is often greater than 50%, making the effective capital gains rate at least 25%. There are exemptions for certain qualifying property, most notably a principal residence and charitable donations of publicly traded stock, and partial exemptions for qualifying farm, fishing and small business property. In Canada, the capital gains tax on property passing to a spouse or common law partner is deferred to the second death — similar in concept to the marital deduction in the U.S.

According to Canadian tax practitioners, the transition from the estate and gift tax regime to the capital gains tax did not lead to significant problems. This may have been largely due to the step-up in cost basis for all assets to their fair market value as of December 31, 1971 — immediately prior to the start of the new rule.

Canadian client advisors affirm that this process continues to work smoothly.For the most part. Canadian residents are aware of the need to keep appropriate records to substantiate losses as well as gains, knowing they will be taxed on the net gain (or loss). Further, technological improvements have facilitated tracking cost basis. This is now routine practice for most financial institutions and advisors, many of whom have served Canadian families for decades and have a wealth of historical data in their files. Occasionally, issues may occur with real estate that has been owned for a long time. Appraisers typically do their best with historical comparables, and are able to arrive at reasonable valuations.

The absence of estate taxes has not reduced Canadians' appetite for wealth planning. However, the focus and structures differ from those currently prevalent in the U.S. As may be expected under a regime where income tax is the primary threat to multigenerational wealth, tax planning is usually designed to mitigate an income/capital gains tax, which some consider a backdoor transfer tax.

Some key techniques are outlined below.

Estate Freeze
This very popular technique involves a corporate reorganization to freeze parents' wealth and transfer future growth to upcoming generations. In a classic freeze, the parents' assets are owned by a corporate entity. The parents exchange their common shares for preferred shares, which receive a fixed dividend but do not participate in any further growth. The parents must receive full fair market value for this exchange, so they may receive further compensation such as a promissory note. The corporation then issues new common shares. The children subscribe to these shares, which accrue future growth but have a de minimis value at issuance. The parents are able to retain control through voting shares or the use of a family trust. Over time, as the wealth grows, the family may do multiple freezes and re-freezes, issuing different classes of stock with different rights. If there is a family business, it is often placed in a separate operating corporation, which is then wrapped in a holding company onto which the freeze is overlaid.

Income Splitting
Beyond freezes, Canadians focus on mitigating income taxes in similar ways as their U.S. counterparts. There is sometimes more opportunity for income splitting among family members, because husbands and wives are treated as separate taxpayers. For example, the wealthier spouse may loan

the other spouse funds at the CRA-prescribed low interest rate. However, as in the U.S., family attribution rules curtail some of the possibilities here.

Life Insurance
For families whose net worth consists predominantly of real estate or a family business, the deemed disposition at death may create a liquidity crisis similar to that experienced by U.S. entrepreneurs and real estate investors facing a 40% estate tax. In Canada, as in the U.S., life insurance proceeds are income tax-free to the beneficiaries, making it an attractive solution.

Trusts
A major difference between Canadian and U.S. tax law is the treatment of trusts. Due to provisions in the ITA, neither *inter vivos* nor testamentary trusts are as popular in Canada as they are in the U.S. Harsh treatment in Canada includes the following:

- There is a deemed disposition and related capital gains tax on the funding of a revocable grantor trust. As a result, the standard U.S. revocable grantor trust is rarely used in Canada.
- There is a deemed disposition and related capital gains tax on all assets in an ongoing trust every 21 years, which severely limits the ability for long-term deferral of capital gains tax.
- Income generated within a trust is taxed at the top income tax rate from the first dollar earned.

Before dismissing trusts entirely, however, it is important to note that for certain specific situations, trusts do figure significantly in Canadians' wealth plans. From an estate planning perspective, discretionary family trusts are often useful for parents wishing to retain control of family wealth while gifting interests to their children. Families may mitigate the 21-year deemed disposition rule by distributing trust assets in kind prior to the 21-year deadline, carrying the cost basis to the trust beneficiaries who, as individuals, are able to further defer the tax.

How the Canadian Model Might Work in the U.S.

To explore the possible impacts of the Canadian tax regime in the U.S., it's important to understand that replacing the estate tax with a capital gains tax at death would have different consequences — and potential benefits — than simply reducing the tax in its current form.

Offers a Lower Tax Rate

At first glance, it would appear that this proposed replacement is an unnecessarily complicated method of reducing the 40% estate tax rate. Why not simply cut the rate to be more in line with the capital gains tax, perhaps to 20%? In practice, however, even a reduction to 20% would not be equal in terms of actual amounts. The estate tax applies to the full fair market value of assets above the exemption amount, whereas the capital gains tax only applies to previously untaxed appreciation of assets. In other words, not only would the capital gains tax rate be a smaller percentage, it would also apply to a smaller dollar amount.

Avoids the Double Tax at Death

One of the more common arguments against the current estate tax rules is that it is an unfair "death tax" on the previously taxed income of financially successful individuals. If you earn income (e.g., a salary or stock dividends) you pay taxes on that income. If that previously taxed income is then subject to an additional 40% tax upon your death, it would appear to be an unfair double tax at death. A capital gains tax avoids this stigma, because it is applicable only to previously untaxed, unrecognized gains.

Encourages More Investments

This kind of new tax policy could provide a benefit to the U.S. economy as a whole. Wealthy families will no longer be incentivized to hold their assets until death to take advantage of a step-up in basis and eliminate a capital gains tax on the appreciated assets. Removing this incentive may encourage wealthy families to sell some of their assets during their lifetime, recognize those gains and re-invest them — leading to an overall benefit for the economy. Additionally, instead of holding large concentrated positions, these families will be more motivated to invest more prudently, reduce risk in their portfolios and focus on a more diversified asset allocation, which is beneficial from a long-term investing perspective.

Harmonizes Tax Provisions

Assessing a capital gains tax when an asset is transferred by gift or at death conforms with the basis consistency rules. Beneficiaries would continue to receive basis information regardless of whether there is a capital gains tax at death or a carryover basis. While it may be difficult to determine the basis of certain assets — especially those that have been held for many decades — this has not been a significant issue for other countries that have a tax on capital gains at death (as discussed previously). Moreover, pursuant to the Emergency Economic Stabilization Act of 2008, most financial institutions are now required to maintain cost basis information for their clients' investments, which could be easily provided to future beneficiaries.

What To Consider from a Planning Perspective

Given the possibility of tax policy changes over the next few years, it is important to build flexibility into estate plans. Because there is no certainty as to the timing or details of the tax policy changes, we recommend estate planning that prevents or minimizes the federal estate, gift and GST taxes, while also incorporating the ability to address any issues that may arise as a result of changes in tax policy. Equally as important are the values of the non-tax benefits from estate planning, such as asset protection, probate avoidance, business succession and asset management advantages.

Minimizing Estate, Gift & GST Taxes

The uncertainty around the fate of the estate tax has not removed the significance of planning around it. Many strategies implemented to remove future appreciation from an estate will most likely continue to be effective, even if the estate tax is replaced.

Specifically, it is still important to pursue estate freeze transactions that do not require a significant risk of gift tax, such as grantor retained annuity trusts (GRATs) and sales to intentionally defective grantor trusts (IDGTs), and to continue to make gifts up to the gift tax exemption.
If the new law is similar to that of Canada, these freeze techniques may make it possible to shift appreciation out of an estate, while deferring any capital gains taxes at death. This should be done sooner rather than later, as there is uncertainty about potential legislative changes curtailing these vehicles.

Regardless of which freeze technique is employed, consider using a grantor trust as a recipient of the gifted assets. A grantor trust is ignored for income tax purposes and allows the donor to make extra gifts to the trust by continuing to pay the income tax on the income of the trust. In addition, most irrevocable trusts, even grantor trusts, generally provide protection from creditors, divorce claims and even some forms of elder abuse.

Building Flexibility into Plans

Naming a trust protector in an irrevocable trust is one way to provide potential flexibility in the future. A trust protector can make limited changes to the trust in the event that changes are beneficial from a tax perspective. For example, the trust protector could shut off grantor trust status should it be advantageous for the trust to become its own tax-paying entity for income tax purposes. This can be beneficial if income splitting becomes an optimal strategy, as it is in Canada.

If the estate tax is repealed and the current basis step-up rules remain, a trust protector has the power to swap low-basis assets held in a grantor trust with higher basis assets held outside the trust. That way, the low-basis assets are included in the grantor’s estate and receive a full basis step-up.

In addition to these considerations for irrevocable trusts, flexibility should be added to current dispositive estate plans as well. Wills and trust formulas are often based on current tax law, which may have unintended consequences if that law were to change. For example, many estate plans use formula clauses stating that the credit shelter trust should be funded with the maximum amount of assets that does not result in a federal estate tax. If the estate tax exemption is changed significantly, other trusts, including the marital trust, may be funded with much more or much less than originally intended. While the spouse may be the beneficiary of both the credit shelter trust and marital trust, this is often not the case in second marriages. Even in first marriages, the spouse may not be the primary beneficiary of a credit shelter trust. So the balance between the amounts in these trusts may be critical to the future lifestyle and even the estate tax liabilities of the surviving spouse.

Other options include alternative provisions in estate planning documents to take effect in the event the estate and GST taxes do not apply, and/or giving an agent under a power of attorney (or a trust protector) the ability to amend an estate plan in the event of incapacity. For example, if the GST tax is repealed, it might make sense for a trust protector to include grandchildren as beneficiaries of a trust — whom would not have been included given the current GST tax.

Planning Beyond the Tax Considerations

In the U.S., wealth planning involving non-tax issues predates talk of abolishing the estate tax. Governance around how a family's assets are managed, and not squandered, cannot be forgotten. Empowering the next generation to have the skill set to successfully manage assets should be an ongoing focus for every family and incorporated as part of any estate plan.

As we noted earlier, there are many parts of the world that do not implement an estate tax. We have learned from wealthy families in these countries that non-tax considerations are often more important than tax planning to the long-term success of the family. Many people who have amassed a certain level of wealth are concerned about family dynamics and preparing the next generation for the family nest egg. For instance, in regions such as Dubai and Hong Kong, where an entrepreneurial culture is a more recent phenomenon, the newly wealthy are increasingly interested in succession planning. They are devoting time and resources to the difficult but critical task of preparing the next generations to handle family enterprises.

Other areas of focus include protecting the family assets from creditors, ex-spouses and political dangers, as well as avoiding relatively high probate, or "death administration" fees. Confidentiality, particularly for those with multinational connections, is rapidly becoming a top priority. As the trend for global transparency forces traditional and formerly very private jurisdictions to report the financial assets of non-residents, the wealthy are seeking structures and countries that have robust data security laws and systems, allowing them to preserve at least some measure of privacy. In fact, some states in the U.S. are currently cited among those offering the best solutions.

In addition, residents in countries without estate taxes are increasingly seeking advice in dealing with the investments and the holdings of family members — often children — who have relocated to high-tax jurisdictions that continue to be attractive for non-tax reasons. Pre-immigration planning for family members, structuring entity ownership, and techniques for tax-free intergenerational wealth transfer are ongoing areas of focus for the many families with connections to the U.S. and the U.K.

For instance, for the many global families who have relatives, homes or financial assets in London, it's important to note that the U.K. is vigorously bucking the global trend away from estate and inheritance taxes. The U.K. not only continues to have a 40% inheritance tax on assets owned at death and on gifts made within the seven years before death, but is also ramping up the taxes levied on trust assets and the property of non-domiciliaries. The new rules and evolving roles of both advisors and their clients require creative estate planning, particularly for wealthy residents in the growing number of countries with no estate tax.

While increased flexibility in estate planning is important to manage tax changes as they arise, it is important to ensure that the grantor's intent does not get lost. Less focus on the tax aspects of planning allows everyone to step back and articulate the primary goal of wealth transfer. In other countries, regardless of whether estate or capital gains taxes are an issue, it is common for the grantor to draft a letter of wishes or a statement of intent as part of their trust planning to give guidance to future generations and to guide the trustee in navigating through periods of uncertainty. Articulating and documenting the values that the family wishes to transfer, rather than just focusing on tax avoidance, leads to the development of a client's legacy and should allow a family to be well prepared to address any current and future changes occurring in the world of estate planning.

Conclusion

At this stage, it is too early to tell precisely what comprehensive estate tax reform might be included in the next presidential and congressional administration. However, significant tax reform is likely on the horizon, and such tax reform will not eliminate the need for careful estate planning.

There is a global precedent for the removal of an estate tax, and residents of other regions with carryover basis still benefit and require estate planning services. Canada serves as one example of what the proposed tax reform may look like in the U.S., which could mean the implementation of a new capital gains tax at death concurrently with the elimination of the estate tax. The uncertainty regarding the future of tax law in the U.S. upholds the need for careful planning, guidance and flexibility within the estate plans of wealthy Americans.

Furthermore, the need for wealth planning extends beyond the tax considerations. This is also evident from looking at global trends, as well as longstanding concerns in the U.S. regarding asset management and protection, succession planning and other legal issues. Given all the potential changes, it is important for clients and their families to work with a collaborative team of advisors who can serve the evolving multi-generational tax, estate, philanthropic and wealth planning needs.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Joan Crain

Justin T. Miller

CITE AS:

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[ii] It should be noted that under U.S. law the step-up in basis at death does not apply to assets that would be considered income in respect of a decedent (IRD) pursuant to IRC section 691, such as 401ks or IRAs.

[iii] Unless otherwise provided, the names, characters, businesses, places, and events discussed in the hypothetical examples in this paper are fictitious. Any resemblance to actual persons, living or dead, or actual events is purely coincidental.

[iv] These irrevocable trusts are often referred to as “Intentionally Defective Grantor Trusts,” or IDGTs.

[v] IRC section 6166.

[vi] Chinese officials proposed an inheritance tax in 1994, and discussed an estate tax in 2013, but neither of these initiatives were enacted.

[vii] Alan Cole, “Estate and Inheritance Taxes Around the World,” TaxFoundation.org (Mar. 17, 2015).

[viii] Ibid.

[ix] OECD Statistics 2010, as quoted by Joshua Rubenstein in “Heads I Win, Tails You Lose,” STEP Journal (Nov. 16, 2016).

[x] Examples include Norway, Sweden, Australia and Israel

[xi] Note, however, that with the current large exemption in the U.S., the majority of U.S decedents owe no estate tax and their heirs benefit from the basis step up.

[xii] When Portugal abolished the inheritance tax in 2004, it instituted a 10% stamp duty

[xiii] Mexico taxes gifts and inheritances received by non-residents at 25%. In practice, the notaries handling the estate settlement do not always provide for stepped up basis on the assets in the hands of the beneficiaries.

[xiv] Income Tax Act, par. 70(5)(a), Department of Justice, Canada.