Not Too Rich, Not Too Poor: Goldilocks Planning for the Middle-Rich Clients Who Need Our Help

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What This Session Will Try To Do

The thesis is that we can accomplish a lot of planning for lots of clients – for most of our clients, in fact – by:

- using well-understood techniques, properly implemented
- not swinging for the fences
- doing a little bit of planning “all the time” as conditions warrant

A collateral observation is that advanced, or esoteric, or exotic, or risky – pick your modifier – extensions of well-understood techniques may be great plans or terrible schemes, but need not be used in most situations, AND, just as importantly, should not scare us off from using the well-understood techniques.

Who Are The Middle Rich?

We Don’t Know Who is Middle Rich … First, Who Is Rich?

Forbes Advisor (July 8, 2022) says $11.1 million is the cut-off for the Top 1% of Wealth in the United States

Coincidentally, Congress says No Estate Tax if You Have $13,610,000

So, Maybe You Are Rich if You have More than $11 - $14 million??

Of course, we know folks with that amount will DENY being rich! But We have to start somewhere

On To the Middle Rich

As a thought experiment …

Does a client who can "solve" her estate tax problem by using only her applicable exclusion set the boundary between Rich and Middle Rich?

Consider a client with a 20 year life expectancy …and $19,000,000 in assets that produce 2% income and appreciate at 5% annually

who gives away $13,000,000 today to a grantor trust …

In 20 years, the trust will be worth about $50 million.

{Applying advanced math skills, we discover the number in the trust would be about $100 million for a couple.}

A Little Bit More About the Experiment

Let's pretend our client lives on the 2% income.

And the client is smart about estate planning.

SO, every year for 20 years the client swaps assets into the grantor trust for the cash needed for the client to live (and of course pay income taxes).

This is a thought experiment, so we are ok assuming constant returns, ignoring capital gains, etc.

What Do We Discover

Our client has given away $13,000,000 and kept $6,000,000

With the swapping, and growth, and income tax, a rough estimate is that the client will die with ZERO

This is obviously nonsense in the real world, but here we are just thinking.

So maybe a Middle Rich client has $19,000,000 today

In reality, there will be some annual gifts, maybe charitable gifts, and this thought experiment has the client living somewhere in an RV that's depreciating to nothing because even in a thought experiment the house isn't appreciating at 5% and producing 2% income…

So let's round up -- maybe the floor for a Middle Rich client is about $20,000,000 today

More Discoveries

If we assume our client has a 30 year life expectancy, the $18,843,000 only increases to $22,750,000 which we might round up to $25,000,000.

Using our working dividing line between Rich and Middle Rich – someone who cannot eliminate his or her estate tax liability merely by giving away the exemption amount to a grantor trust now and swapping assets for income is Middle Rich – then our floor for an individual is current assets in the $20 - $25,000,000 range.

You need at least $20/$25 million to be Middle Rich, and roughly $50 million to be Middle Rich if you are a couple.

Idea Number One
Flexibility in the Marital Trust for the Surviving Spouse

The first question is still the first question: is the surviving spouse in charge? No, then who is? Inform the client, and document the choice.

Other basics:

- How is the DSUE preserved?
- Does the spouse need to benefit from everything, or only part? How can we reassure the spouse (and the family)?

We can predict that the surviving spouse will want to make gifts (to someone), or the family will want gifts made (to them).

- Draft with controlled principal distributions in mind.
- Trustee discretion? Power of appointment to spouse?
- Suppose trustee may give the spouse assets equal to the amount the spouse gave to the family in the previous year.
- Existing trusts: Beware QTIP terminations. CCA 202118008. Anenberg. McDougall.
- Using 2519 directly? What about "discounting" within the QTIP?

Idea Number Two
The Test Trust

Each beneficiary is a singularity. Even if TODAY we are treating children identically, or grandchildren, or nieces and nephews, they are not identical, not today and not tomorrow. The more you know about them, the more you can help your client, and the more you can avoid problems for your client, your client's family, and yourself.

Discuss with the client the Beneficiary Advised Trust versus the Protector Advised Trust. They are different things, each with many variations.

Consider a *Test Trust* for a Beneficiary: a small amount of money in trust over which the beneficiary has some degree of influence.

- May be an existing trust (e.g. a Crummey trust share) or new.
- The choice of assets is important.
- Counsel, advice, instruction by the donor and perhaps others is important too.

Idea Three
Making Gifts to Grantor Trusts:
The Backbone of Middle Rich Planning

Gifts remove appreciation from the client's taxable estate.
Yes, not all assets appreciate, but most of our clients think THEIR assets will appreciate!

Gifts generate income outside of the client's taxable estate which can be used to buy other assets from the estate, and when the cash is spent the client's net worth declines.

We like gifts because the estate tax system continues to allow assets to be discounted in many, if not most, situations via the Willing Buyer/Willing Seller standard, Rev. Rul. 93-12, etc.

The amount of the gift matters less than that some gift is made! Get Started!!

A funded grantor trust can facilitate:

- Swaps
- Sales
- GRATs
- Joint purchases
- Private Annuities
- Charitable Gifts

The Middle Rich Will Make Gifts If They Are Not Giving Up Control or Income

Control. Investment control is comparatively easy to secure because non-voting entity units can be given and voting control retained. Beware 2036(a)(2) if any interest is retained, so remind clients to divest themselves of the 1% as soon as possible.

Distribution control is harder to deal with. Fiduciaries may be "inspired" by the grantor (look at the Goodwyn cases, for instance) with less tax risk than changes by the exercise of a power of appointment during the grantor's lifetime (or a beneficiary's lifetime, for that matter).

Beware the "trust protector" who is not a fiduciary and follows the direction of the grantor.

The Middle Rich Will Make Gifts If They Are Not Giving Up Control or Income

One way to make a gift and not give up income is to give away assets that produce little to no income. Raw land, farms (even if a little income), and life insurance may be great assets to give away because they do not present the issue of retaining income.

Ensuring that assets/income are available to maintain the assets given away is key. That may be life insurance premiums, but it may also be property tax and liability premiums on land.

Annual exclusion gifts may be used, via Crummey powers.

The Middle Rich Will Make Gifts If They Are Not Giving Up Control or Income (2)

You could suggest a Domestic Asset Protection Trust, and have the grantor be a beneficiary. There is a financial cost associated with this approach, and there is not much published authority guaranteeing success.

Or, you could suggest using the Spouse as a friendly beneficiary. The risks are the spouse becoming less friendly, or dying. In recent years, the marketing term "Spousal Lifetime Access Trust" or SLAT has come to be used to describe these trusts.

Often both spouses want to create SLATs. They must be different, and no one is sure how different. One approach is to not have a spouse a beneficiary of one trust at all, with the ability for the spouse to be added later.

A Sale Might Help Secure Income Too

A gift to a grantor trust followed by a sale to the same trust may allow the grantor to "retain" the income of the gifted assets.

For instance, suppose $10 million is given to a grantor trust, which produces 2% income annually. Then the client sells another $5,000,000 to the trust. So the trust has $15,000,000 of assets, and $300,000 of income. If the $5,000,000 were sold for a note with an interest rate of 4%, the note may be amortized over about 28 years at $300,000 a year. As income increases every year, the additional income may be paid on the principal.

If desirable, $200,000 or so of the $5,000,000 could be sold to the grantor trust note for a traditional note but rather for a deferred private annuity that would begin in 20 or 25 years to "replace" the lost income from a satisfied note.

Sales and GRATs

A Sale as a means of retaining income can work, but so can a sale with the primary purpose of transferring appreciation. The issues surrounding sales to grantor trusts are well known.

- The need for trust assets or guarantees at the time of the sale.
- Limited authority for what happens at death (but authority may be coming).
- GST exemption can be allocated at the time of the seed gift.
- Flexibility beyond the mandatory payment of income, and sufficient principal to make the note to be recognized as a real note.

A GRAT requires no seed gift and uses a lower interest rate than a sale. On the other hand, GST tax exemption cannot be allocated to a GRAT by the grantor at the time the GRAT is created. Transfers to a GRAT are *generally* thought to be protected from valuation challenges by the IRS. (But CCA 20215201 8)

Private Annuity

IRS actuarial tables are always a decade behind

And are unisex tables – women live longer

And are a cross-section – include poor people

Rich people live longer than poor people

So … check the rates BUT you really need someone who is sick OR

You need to be doing the private annuity to soak up extra income – in other words you do a note but the assets produce more income than you need to pay on the note, but the income needs to come back to the client – private annuity is perfect, tied to the extra income. Doesn’t matter how long the client lives in that case.

Valuation Uncertainty

We have no fail-safe method of ensuring that the IRS does not challenge the valuation of assets we transfer by sale or gift.

The methods fall into several categories, and continue to evolve in response to IRS challenges.

A gift with the excess returned is ineffective,

> but if the excess is paid to an independent non-taxable beneficiary (like a charity) via a clear formula, it will be effective.
>
> Similarly, a gift of a properly crafted fraction of the client's total ownership should work.

Remember the risk: yes there is no gift, but more may be retained by the client than expected, and the retained assets may appreciate …

Where a Middle Rich client can make a gift and then do a sale, with room to spare before using all of the client's Applicable Exclusion Amount, the risk of revaluation can be minimized by filing a gift tax return and waiting for the statute of limitations to expire. That may "waste" exemption if it drops at the end of 2025, but in some instances a client will not make a larger gift anyway.

Disclaimer to a Charitable Fund

This is essentially the equivalent of a defined value clause. See, for instance, Estate of Helen Christiansen v. Commissioner, 130 T. C. No. 1 (2008) (reviewed*),* aff'd, 586 F.3d 1061 (8th Cir. 1061).

Can also be used as an equalization device. Suppose all descendants have "enough" money. Some are charitable, others are not. Shares may be created for the descendants that are charged with their own share of federal and state transfer tax. A descendant who prefers charitable dollars to tax can disclaim. Other descendants need not. Each descendant can make a decision after the donor's death based on the circumstances.

Disclaimers to private foundations are problematic. See Private Letter Rulings 200616026, 9320008 and 9008011.

Disclaimers to donor advised funds are fine because "advice" is not control. See Private Letter Rulings 200518012 and 9532027.

The Effect of Retirement Plans and IRAs on the Need For Income

We know that leaving funds in the retirement plan/IRA wrapper will, assuming comparable net investment performance, provide better overall results than will removing the assets.

However, the overall estate tax situation of the client should be considered. If a client will make larger gifts if the plan involves withdrawing more money from qualified plans than is necessary, then an analysis should be made of the overall better plan. Often distributions in addition to the required minimum distributions are a helpful "reserve" for the client (or the client's spouse) that can help reassure the client who is considering gifts.

Where charity is a part of the client's plan, both during life and at/after death, qualified plan distributions are efficient means of funding.

Idea Four
Upstream Planning

Upstream Planning May Allow Your Middle Rich Clients To Make Gifts But Still Obtain A Step-Up In Basis

Goal: do our best to make sure **every individual** dies with an estate of $13,610,000 so we get NEW BASIS

Crummey trusts, gift trusts, trusts that are funded by GRATs and sales, old family trusts. Sometimes, assets can be moved up if there aren't any existing family trusts.

The powerholder should be sick, and is often old, and should have minimal risks of creditor claims

Easiest method is to add a ***Circumscribed General Power of Appointment*** to a trust.

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Circumscribed General Power of Appointment

A testamentary power

To appoint assets to the creditors of the powerholder's estate

Only with the consent of a non-adverse party

And only assets that have a fair market value in excess of basis

With an overall cap of the amount subject to the power equal to (1) the fair market value of the powerholder's estate minus (2) the basic exclusion amount minus (3) $10,000

If certain designated assets should be subject to the power first, then that should be referenced

Upstream Power of Appointment Trust

You have two people: a Grantor with assets who wants basis and an Upstream Person with an estate of less than the basic exclusion amount (and who perhaps is old and sick)

Grantor creates a grantor trust.

Grantor sells assets to the grantor trust for a note.

The Upstream Person guarantees the note.

The Upstream Person has a circumscribed general power over the trust.

After the death of the Upstream Person the trust assets pay off the note.

UPSPAT Management

If the Upstream Person has insufficient assets for the guarantee to be meaningful then additional guarantors may be needed for the note to have a fair market value equal to face value and thus to avoid a gift by grantor.

The Upstream Person guarantee is real so if the assets depreciate in value it will reduce the Upstream Person's actual estate – may need to be adjusted.

As long as the circumscribed general power is not exercised the trust remains a grantor trust.

If the trust assets appreciate then who will receive the excess beyond the amount of the note? Ideally the assets would roll into a trust for the beneficiaries of the Grantor.

Idea Five
The Odd World of Transfers and Sales Within Trusts

One trust may be the owner of another for income tax purposes.

If so, then assets may be swapped between those trusts without it being a sale. PLR 201633021, and PLR 202022002.

And, sales may occur between those trusts without income tax.

Examples include between GST tax exempt and non-exempt trusts, and between trust shares for different family members if appropriate arrangements have been made so that, when needed, one trust may become the owner of the other.

Idea Six
Charitable Interests
Key Points In All Circumstances

A non-charitable client shouldn't make charitable gifts.

Appraised value is key for any transaction that is fun and interesting.

Do not neglect the choice of the charitable recipient: public charity, donor advised fund, supporting organization, private operating foundation, private foundation. If all of your clients want to use only one of these, is your advice broad enough?

Beware the Pre-Arranged Sale. Hoensheid. "Practically certain" test.

Acknowledgment Letters. Just get them. No exceptions.

The private foundation prohibited transactions are not audit risks you can afford to run.

Form 8282.

Avoid the section 338 rabbit hole

Gift of a Remainder Interest in a House or Farm

What's a house or farm?

One life or two

Valuing the Remainder Interest

But I have an *ancestral home*

What if a donor gives a remainder interest to a public charity. After a period of time, the children, grandchildren, a trust for the children or grandchildren, offer to buy the remainder interest for fair market value from the charity.

Estate of Blackford v. Comm'r, 77 T.C. 1246 (1981), acq. in result 1983-2 C.B. 1; Rev. Rul. 83-158, 1983-2 C.B. 159; PLR 8141037. See also Rev. Rul. 84-97, 1984-2 C.B. 196, in which a gift of a remainder interest in a farm was determined to qualify for an estate tax charitable deduction even though the applicable state mortmain statute required the charitable recipient to dispose of the farm within 10 years of acquisition.

Charitable Distributions From Trusts

If a trust allows distributions to charity then section 642(c) allows the deduction for income only, not principal.

Trusts may not be amended to add a distribution provision to charity. However, Rev. Proc. 2004-5 provides a useful work-around: form an LLC in the trust and make distributions to charity from the LLC.

The 501(c)(4), (5), (6) As A Private Foundation Work-Around

In 2015, section 2501(a) was amended to specifically exclude from federal gift tax lifetime gifts to 501(c)(4), (5), and (6) organizations.

There is NO similar provision with respect to the federal estate tax. So this is a lifetime gift technique.

As a general matter, donors should be wary of section 2036 applying to transfers to the organization

- For example, a lifetime transfer by Donor to a 501(c)(4) organization that Donor controls, either alone or in conjunction with others, may be included in Donor's estate for estate tax purposes.
- The included amount would not be offset by a charitable deduction.

Work-Around Examples

Scenario: Donor wants to contribute significant interests in a privately-owned corporation to her private foundation at death

Problem: section 4943 would preclude the private foundation from long-term ownership of more than 20% of the voting stock of corporation in combination with all disqualified persons.

Scenario: Donor's family wishes to engage in multiple transactions with family foundation

Problem: Most transactions between disqualified persons and a related private foundation are prohibited under section 4941

If a 501(c)(4) organization is not a disqualified person – even if it is controlled by one or more disqualified persons -- it would be permissible for a private foundation and that 501(c)(4) organization to enter into transactions that ordinarily would be treated as self-dealing.

Charitable Lead Annuity Trust.

Where a client's estate plan leave assets to charity, consider instead creating a testamentary charity lead trust. If the assets outperform the 7520 rate at death, the children receive "free" money. The cost is to the charity which will not receive the entire bequest until the CLAT term ends.

Interest rate sensitive – like a GRAT.

But not mortality sensitive, so longer terms can be used.

And, payments can be shifted towards the back-end which will likely produce more for the family beneficiaries at the end.

Thank You!

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