**What Estate Planning Should You Do Now That Congress Might Not Change Anything**?

**Changing Winds of Tax Legislation**

Congress was considering tax changes that would have triggered capital gains tax on death, when gifts were made, and every so many years for assets in trusts. Congress was considering reducing the exemption, severely restricting the use of grantor trusts which had been the foundation of estate planning for decades, and much more. But the latest iteration of tax law changes has nary a direct impact on the estate tax system. Does this mean that wealthy taxpayers in the midst of planning, or still contemplating planning, should disconnect the Bat Phone to their estate planner? That really doesn’t seem prudent. Does this mean that taxpayers that implemented large wealth transfers should be calling their estate planner to find out how to unravel those plans? Probably not the right dance move for this prom. Well then, what should folks be doing now in light of this sharp right curve on the tax road? Probably plan, plan prudently and reasonably, considering the same factors that sound estate planning always entailed. Some of these will be reviewed in the following discussions in light of the current estate tax planning environment.

**Uncertainty Still Reigns**

Significant uncertainty remains over what the outcome of any proposed tax legislation will actually be. While the latest “iteration” of the proposals appears to have few changes to the estate tax system, the situation still remains a “toss-up” as it is impossible to predict what changes might be made, or what restrictions added back to the tax proposal, as the plan winds its way through Congress. Nothing may change. Yes, after all the talk and planning panic, no estate tax changes may be enacted. It is also possible in upcoming negotiations some of the harshest proposals could still be enacted to pay for the spending program. Senator Sanders’ proposals, which are rather harsh in its impact on estate planning, is already in legislative format. That means it would take little time or effort to paste a provision into proposed legislation if needed to make the revenue numbers comparable to the spending figures. This uncertainty is one of several reasons why taxpayers should continue to plan. We just don’t know!

**Special Income Tax Surcharges May Impact Many Trusts**

The current proposal targets high income taxpayers. There is a special or additional tax of 5% on income above $10 million. And if income exceeds $25 million there is an additional 3% surtax. The 5% surtax will apply to trust income at a mere $200,000 of income. This will change how many common trusts are handled, e.g., the credit shelter or family trust formed on the death of the first spouse. Grantor trusts appear to remain so they will be taxed to the settlor (or other person who is deemed the grantor for income tax purposes). However, non-grantor trusts (also called complex trusts) generally pay their own taxes and will have to be carefully monitored.

More specifically, a non-grantor trust pays tax on all income it earned but it receives a deduction for the income (distributed net income or “DNI”) distributed to beneficiaries. That is loosely based on the theory that trusts pay tax on income earned but that distributions of income to beneficiaries carry that income out of the trust to the recipient beneficiary. The logic of that is the “wherewithal to pay” concept. Since the beneficiary has received a distribution that beneficiary, not the trust, has the economic wherewithal to pay the income tax on that particular batch of income. Facing much higher surtaxes will result in several changes to non-grantor trusts. These might include:

* It may be more advantageous to permit trusts to make charitable contributions. But if that is done the contribution must be made from gross income of the trust to qualify for an unlimited charitable contribution deduction. Also, the IRS requires that the governing instrument permit contributions. If not, no deduction will be permitted. If a trust doesn’t have the requisite language, it cannot be amended (e.g., via a merger or decanting) to add that required verbiage. The IRS views the requirement as having to be in the original governing instrument, not a modified later version. All is not lost; however, it may be possible for a trust to contribute assets to a partnership that invests and pays charitable contributions. When the charitable deduction flows through from a partnership to the trust that owns an interest in that partnership the IRS seems to respect the deduction. So, going forward, charities will be more commonly named in trusts.
* Trusts that can be maintained as grantor trusts might be continued in that manner to avoid the harsh trust income tax surtax.
* Trusts that are characterized as non-grantor trusts that may then face the surtax should make a concerted effort to review their tax status before year end. Trusts should have the wealth adviser evaluate gains and income, the CPA for the trust evaluate the tax status of that, and the trustee to consider possible distributions (e.g., what is appropriate for the beneficiaries and what does the trust agreement permit). Then this data should be evaluated and distributions made before year end to shift income from the trust that may face maximum income tax rates and a surtax to the beneficiaries who may be in a lower graduated income tax bracket and not fact the surtax. The savings each year could be substantial (or not).
* When planning and drafting trusts, consider including a wider class of beneficiaries so that the trustee has more flexibility to distribute income to multiple beneficiaries that may be able to remain, even with trust distributions, in lower income tax brackets and avoid the new high surtax rates. Give trustees discretion to make distributions so that they have flexibility to better plan trust/beneficiary combined income tax results. Mandatory income distributions remain potentially problematic from a creditor protection perspective, but also may serve to limit income tax planning flexibility.
* Consider creating special withdrawal powers so that a beneficiary is deemed to be the owner of certain trust income so that the income earmarked will be taxed to the beneficiary and not to the trust.
* Before any distributions are made the trustee will have to consider whether the beneficiaries face any claims or lawsuits that may result in an ex-spouse or creditor attaching the larger distributions that income tax changes might motivate. Also, the beneficiary’s personal income tax will have to be considered. The beneficiary may also be in the maximum income tax bracket so a distribution may have no salutary effects. Worse, if the trust has situs in a low or no tax state, e.g., Florida, but the beneficiary resides in a high tax state like California, the increase in state income taxation from a distribution may outweigh the federal income tax benefits.
* Finally, if the trust is to have certain income, e.g., capital gains income, taxed to the current beneficiaries rather than being taxed to the trust, either the trust instrument will have to permit that income to be taxed to the beneficiaries or the trustee may have to take certain actions to achieve that result. It may be feasible to decant the trust into a new trust with different provisions if that becomes necessary.
* These provisions will have a wide ranging and unexpected impact. They will become the proverbial “traps for the unwary” taxpayer. Someone with a small irrevocable trust they created for a grandchild, or on the death of a spouse, etc. could unexpectedly face a much higher income tax rate just from the sale of a security to raise cash for distributions.

While the application of the income tax surtax is perhaps less harsh then the massive grantor trust changes contained in other proposals, the application of income tax surtaxes at such low levels of trust income continue the theme that Congress seems to believe trusts are bad things really wealthy people use to evade taxes. The reality for most trusts is more moderate taxpayers are seeking to protect their family, now they may get caught by unexpected high tax rates.

**What Estate Tax Planning Should You Do**?

It still makes sense to get appropriate and comfortable planning completed. These are key points, any planning must be appropriate for you, and comfortable to you. You should not pursue planning just because your bowling buddies all told you they have SLATs (or some other acronym). You should also not pursue planning just because your estate planning Yoda determines is consistent with the Force. If you won’t sleep at night, the planning may not be right for you. So, planning has to make sense for your circumstances and not disrupt your inner calm.

Remember the famous Star Wars quote from Yoda, Esq.: “Do tax planning or do not do tax planning. There is no try.” – Yoda.” In the current environment, get off the fence and make decisions as the time to do so may be short.

Specific steps you might evaluate with your advisers in these waning hours before we know the results of the legislative efforts.

**Timing of the Essence**

Not knowing what tax changes might be enacted, when they will be enacted, or when they will be effective if enacted, time remains of the essence to complete planning before a law change. Again, no one can predict what will happen so it may be best to get your planning done if it has not already been completed. Bear in mind that some of the proposals used the date of enactment as the effective date for the new harsh rules proposed. There was even a rumor that the date of announcement of proposed legislation could be made the effective date to prevent taxpayers from completing last minute planning. So, the bottom line remains if you are going to plan, best complete it as quickly as possible, “just in case.”

**Exemption Use Now Even if it May Not Be a Use, It or Lose It Situation**

A still recommended planning step is to use as much of your gift and generation skipping transfer (“GST”) tax exemption as is appropriate before it might be reduced. Senator Sanders proposal was to reduce the gift exemption from $11.7 million to a mere $1 million. President Biden proposed reducing all exemptions from $11.7 million to an inflation adjusted $5 million (which would mean about $6 million and change in 2022). There is no mention in the latest variation of the tax proposals to reduce the exemption. So, why still plan to use it? As discussed above we still do not know what might eventually be enacted. Further, even if the exemption is not reduced in this round (and there is still no certainty of that) the exemption is scheduled under current law to be reduced by half in 2026 without any need for a law change to make that happen. So, planning to use exemption now before that change seems prudent regardless of the outcome of the current proposals. But if the current proposals take another sharp curve and reintroduce a reduction in the exemptions, you’ll be a happy camper if you have already completed your planning and used your exemption in a manner that preserves it. So, why wait!

How you use your exemption is quite important. That is discussed in later sections.

**Grantor Trust**

It seems prudent to create grantor trusts that may be respected even after the possible enactment of harsh laws restricting their use (in tax terminology those trusts are said to be “grandfathered”). If the very harsh restrictions that had been proposed to restrict or eliminate grantor trusts are not enacted, having such a trust in place might prove a useful component of your future planning. Further, since there is no certainty that these changes may not be added back to final legislation taking the precaution to have these trusts in place now seems sensible. Weigh the possible benefits of having a grantor trust created, e.g., to purchase life insurance in the future, to use as part of asset protection planning, etc. versus the cost of creating it. If you have doubts you may be able to create a less costly trust more quickly if it is only going to be a standby. So, instead of creating a trust with an institutional trustee in a trust friendly jurisdiction (e.g., DE, AK, NV, etc.) create a trust in your home state naming a family member as trustee. The cost will be less but you might still secure many of the benefits of a grandfathered grantor trust should that become useful. In the future, if the trust is used in a meaningful manner, it can have the situs and governing law changed to a better jurisdiction (e.g., move the trust then from say California to Alaska).

**Flexibility Is More Important Than Ever**

Flexibility is vital to any planning given the significant uncertainty. You want options to modify and tailor an irrevocable trust and plan for whatever should eventually occur with tax legislation in Washington. And whatever is the outcome of the current tax legislative process, there may again be significant changes after the 2022 or 2024 elections. Integrating flexibility is vital. Effectively, your trust might be use somewhat of a “kitchen sink” approach to planning and drafting. Consider including several provisions in the trust documents to permit you to modify or change the trusts or planning to provide flexibility in light or the uncertainty. Some of the provisions to include:

* Decanting provision to permit the trustee to decant into a new trust (although some of the proposals may have restricted decanting and those might yet be enacted). This would supplement any state law rights to decant.
* Disclaimer provisions that might permit a person designated as a primary beneficiary to disclaim all assets transferred to the trust and that if such a disclaimer is executed that the assets would revert back to you as donor/settlor. In the typical application of a disclaimer, it would be treated as if the disclaimant predeceased you and the other trust beneficiaries would then take. So, this would be a somewhat novel application of the disclaimer mechanism. There is no law confirming that this will with certainty work, but if it does it could provide you with a mechanism to unwind the entire transaction. Some commentators suggest instead creating an initial trust that has only that one beneficiary, and later using powers of appointments to shift assets to a new trust. But will the limited time remaining before legislation is enacted permit that to be crafted?
* A provision permitting the trustee to disclaim. That too may raise issues that a disclaimer could be violative of the trustee’s fiduciary obligations to all of the beneficiaries.
* A provision for a named person to “turn-off” grantor trust status (i.e., convert the trust from a grantor trust for income tax purposes into a non-grantor or complex trust that pays its own taxes). The purpose of this would be to assure the ability to change the trust’s income tax status if that proved advantageous in light of the proposed harsh restrictions on grantor trusts. Even if those restrictions are not enacted this provision should not cause any detriment but hopefully would just preserve flexibility for future planning options. The person holding this power should act in a non-fiduciary capacity. If the person is acting in a fiduciary capacity their obligation to the beneficiaries might conflict with this power.
* Name a trust protector and authorize that person to change trustees, situs, governing law, administrative provisions, etc.
* Depending on the assets to be transferred to the trust and your feelings concerning those transfers it may be feasible and advisable to incorporate express language into the transfer documentation permitting the transfers to be rescinded. Recission of the transaction within the same tax year may obviate any income tax consequences of the transfer. The use of recission may be useful if some of the proposed changes are enacted in a manner that could have your transfers deemed to trigger adverse current income tax consequences. Again, these types of changes are not in the current version of the tax proposal but it is unclear what might yet be enacted.
* Give the power to the trustee to divide the trusts in the event that becomes useful, e.g., to take different actions to modify different portions of the trust differently.
* As discussed elsewhere, name a large class of beneficiaries, including charities and give the trustee flexibility to include capital gains in income and to have broad discretion to distribute income and perhaps principal out of the trust.
* Consider whether it make sense to include a power for a persona, perhaps referred to as a “charitable designator” (which would make the trust under current law a grantor trust). This might provide further flexibility. Consider recommending to clients that they establish a donor advised fund and name that fund as a permissible beneficiary, so the client has a potential charitable donee even if they do not have a particular charity they want to benefit now.
* Other steps might be taken as well.

**Accessibility**

It is advisable for most taxpayers to structure the trust or trusts they create in a manner that permits access to trust assets after the transfers but which does not undermine the tax goals (removing assets from your estate) or asset protection goals (making it difficult for creditors to reach the assets). While those goals are somewhat contradictory all may to some degree be accomplished. A number of steps might be considered to do this. These can be grouped into two categories. The first is the general structure of the trust or trusts you select.

* DAPT – A Domestic Asset Protection Trust is a self-settled trust that you could create of which you are also a beneficiary. Under the laws of 19 different states, you could make a gift to such a trust, be a beneficiary in the discretion of an independent trustee (perhaps, or preferably, an institutional trustee), yet the assets arguably are outside your estate and unreachable by your creditors. Because of the perceived risk according to some commentators of DAPTs (especially if you live in a state that does not permit such trusts), it may be preferable to use one of the approaches below.
* Hybrid DAPT – This is a trust for the benefit of your spouse/partner and/or descendants initially. So, it appears initially no different than the SLAT below. However, you would grant a person (or committee if you prefer) the power to add as beneficiaries any persons from a class consisting of your grandparent’s descendants, which obviously includes you. So, you could be added back as a beneficiary in the future should you need that mode of access to the trust. The theory behind this concept is that you are never a beneficiary of the trust until added back so whatever incremental risk exists for a DAPT is arguably not as great in the context of a hybrid-DAPT.
* SPAT - This is a trust for the benefit of your spouse/partner and/or descendants initially. So, it appears initially no different than the SLAT below. However, you would grant a person (or committee if you prefer) the power to direct the trustee to pay over trust principal or income to you (or a class of people that includes you). That person expressly would not have the power to add anyone as a beneficiary (including you), so that the trust should never be characterized as a self-settled trust. Since principal could be appointed to you should you need access to the trust, the SPAT can provide greater protection than the mere SLAT below. The theory behind this concept is that you are never a beneficiary of the trust and cannot be added as a beneficiary so whatever incremental risk exists for a DAPT is arguably not as great in the context of a SPAT. Bear in mind that there is very little relevant law on the above concepts.
* SLAT – Spousal Lifetime Access Trust (and it doesn’t have to be a spouse, it could be a sibling or anyone else). This is a trust for the benefit of your spouse/partner and descendants. This should have less risk than the preceding three trusts, but also less access.

Note that there is no means to weigh the relative risk of each of the options. Also, how well the trust is administered will be critical to achieving any of the above objectives.

Additional trust access provisions (used in any grantor trust structure).

* Loan provision which authorizes someone you designate to loan trust funds to you without regard to whether you post adequate security (but may be required to pay adequate interest to avoid estate inclusion). While you might owe money to your trust the key is that it assures you access to trust assets and the cash flow you might need.
* Authorize the trust to purchase personal use assets, e.g., a vacation home, artwork, etc. That way, so long as you are married to the spouse you named as beneficiary, you may have use of these assets as a result of his spousal relationship.
* Charitable gifts should be permitted. If you wish to do this the trust could make donations that you might otherwise have made yourself. The trust, however, cannot discharge any pledge or other obligation you might have.
* Tax reimbursement clause that permits the trustee to reimburse you for income taxes you incur on income earned inside the trust. While some of the tax proposals may have eliminated this mechanism, under present law and the current/latest tax proposal this has not be restricted.

**Plans Should Make Sense Regardless of Tax Laws**

Planning should make sense regardless of what happens with the tax laws since there may be no material changes to the estate tax yet there is still a possibility of significant change. If, without tax motives/benefits, you might not do the planning then you might reconsider whether anything should be done. However, to the extent that the assets moved into trust safeguard the exemption that is scheduled to decline by half in 2026, then planning now may be sensible regardless of the outcome of current legislative proposals. Planning may enhance asset protection (from claims, creditors, etc.) so thus may be beneficial in all events regardless of tax law changes.