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NEWSLETTER OCTOBER 2021

To Our Clients and Friends:

In this Newsletter, we want to continue to update you by briefly covering topics of the most current interest to our clients. We have rushed this Newsletter to you to alert you to changes pending in the tax bill currently being considered by Congress and planning opportunities that may be disappearing. This brief article is general in nature and you should not rely on this summary because there are so many individual factors to be considered and there is no certainty what the final tax bill will be. You are advised to contact us or another tax professional to discuss taking any action.

I. Pending Congressional Tax Bill, with Significant Adverse Estate Planning Impact

Congress is negotiating a new tax bill designed to raise revenue for the President's "Build Back Better" plan. It contains significant changes to estate and gift tax laws, and to related income tax laws. This Newsletter focuses on the changes that will impact estate planning. We advise you to discuss the proposed income tax changes with your accounant.

At this point, we can only speculate about the final version of the bill; however, we want to warn our clients about potential key changes and immediate planning opportunities. As currently written, if the bill passes, some changes will be effective on the date the bill becomes law, others will not be effective until 1/1/22.

A. Reduction in Estate Tax Exemption

The estate and gift tax exemption is currently $11.7M per person. A reduction is proposed to lower the exemption to around $6M per person. Gifting more than $6M and up to $11.7M per person can be done before 1/1/22 in order to take advantage of the current high limits. These large gifts may be feasible for clients with sufficiently large enough estates who would retain enough assets to maintain their desired lifestyles and who are not concerned about Prop 13 impact if California real property is gifted.

B. Minority and Marketability Valuation Discounts may Disappear for Some Assets

Currently, partial interests in entities which are gifted or transfered on death are eligible to receive minority and/or marketability discounts to reduce the value reported on the gift or estate tax return. However, the proposed legislation would eliminate these discounts for entities holding nonbusiness investments. The types of entities that would continue to be eligible for the discounts are entities holding assets used for a closely held business, and entities holding income producing real property used in the active conduct of a real property trade or business in which the taxpayer materially participates.

C. Effective Elimination of the Benefits of Grantor Trusts

The proposed bill targets new grantor trusts and contributions to existing grantor trusts. Grantor trusts have been used to remove assets from one's estate, while the taxpayer is still treated as if he/she still owns the assets during life for income tax purposes.

The proposed bill would affect grantor trusts in three important ways. First, a grantor trust would be included in the taxable estate of the grantor at death. Second, any distribution from a grantor trust to a beneficiary (other than the grantor's spouse) would be a taxable gift. Finally, sales between the grantor and that trust which previously were "disregarded" for income taxes, will now be a taxable event, causing the recognition of taxable gain (but recognition of taxable losses would be disallowed). The following discusses some of the impact this could have on several common types of grantor trusts used in estate planning:

1. Life Insurance Trusts. The impact of the tax bill on life insurance trusts is probably an unintended consequence of the bill's broad coverage. It is very common for clients to have created a grantor trust to own their life insurance policies such that the life insurance can be received by the trust beneficiaries without any estate tax at death.

Clients with an estate valued at less than $6M, including the life insurance held in trust, may not be concerned about the trust being included in their estate, as they do not expect to have a taxable estate on death.

On the other hand, clients who expect to have a taxable estate and desire to keep the entire value of the life insurance policy out of their estate may need to act quickly to avoid the effect of this proposed law. The law will not apply to existing trusts so long as no contributions are made by the grantor after the effective date of the law. If you are still making contributions to pay the policy premiums and will have a taxable estate, we urge you to contribute funds ASAP (before the pending tax proposal becomes law) to pre-fund premiums for at least the next year or next few years (but be careful to consider the annual gift tax exclusion amount and the "Crummey Notices"). Contact us immediately to discuss a plan of action for your irrevocable life insurance trust that is best for your family. Many practitioners hope that the impact of any new law on standard life insurance trusts will be relieved by Congress or by the IRS, but we should make plans for "just in case" that isn't the case.

2. Sales to Defective Grantor Trusts. In the past, sales to grantor trusts were used to remove appreciating property from the grantor's estate, using a tax-free sale to avoid capital gains tax, and where the transferred property has income of more than the nominal IRS-mandated interest rate, allowing parents to shift future income and appreciation to their children. Grantor trusts already created and funded for this purpose will not be affected, so long as no new contributions are made to the trust. Those who want to "sell" income-producing property to children, for a "seed gift" equal to 10% or more of the value of the property must create the trust and sell the property for a down payment and a promissory note, all prior to the new law's date of enactment (being cognizant that use of CA real property may result in property tax reassessment).

3. "SLAT's". Spousal Lifetime Access Trusts will be eliminated for spouses who want to irrevocably gift properties or assets to each other for estate tax purposes.

4. The benefits of Grantor Retained Annuity Trusts ("GRATS"), used to retain an annuity stream for a number of years, with the remainder to beneficiaries at a discounted gift

value, and qualified personal residence trusts (QPRTs), used to transfers homes after a certain number of years to beneficiaries, also at a discounted gift value, will be eliminated.

Clients wishing to use grantor trusts in their estate planning must act fast to have these trusts established and fully funded and any sale transaction completed prior to the enactment of the law.

D. Stepped-Up Cost Basis

The current law is that the cost basis of assets is "stepped-up" to the asset's fair market value as of the date of death, which then reduces capital gains tax that will be owed when the asset is sold by your beneficiaries. While stepped-up basis had been on the Biden "hit-list," thankfully, no repeal of the stepped-up income tax basis at death appears to be included in this bill.

II. Opportunities with Props 13 and 19 – Planning to Maintain Low CA Property Tax

As we wrote to you last year, Prop 19 changed the law so that real property transfers between parents and children will cause the property to be reassessed for California property taxes, except in the narrow situation of a transfer of the parent's primary residence to the child, who uses it as the child's primary residence (see our December 2020 Newsletter).

However, a limited opportunity remains to avoid reassessment with transfers through entities, such as a LLC, which avoids reassessment until more than 50% has changed ownership or a new member obtains control. Thus, if parents own 50% and children already own 50% of the real estate, and all transfer title to a LLC, when the parents die, only 50% of the ownership transfers. As a result, the property tax base of the property won't change until an additional percentage is transferred or if a new member obtains control by holding more than a 50% interest. Sometimes these transfers using LLC's are made over the course of several years to get the desired results. There may be ways to avoid full or partial reassessment with careful planning and a long time horizon.

III. The Homestead Exemption

CA law, effective 2021 made the homestead exemption, protecting individuals from judgment creditor liens, much more attractive and useful when the amount of protected equity in your home increased from $75,000 to around $600,000 in Los Angeles County (the amount varies from between $300,000 to $600,000 depending on the median home price in the prior year for your county). There is an automatic homestead that applies to protect against a forced sale if the net equity is less than the homestead exemption. There is also a "declared homestead" that protects the equity, up to the protected amount, from a voluntary sale for up to six months while you look for a replacement home. A "declared homestead" is signed and notarized and recorded with the county recorder prior to a later-recorded involuntary judicial lien.

IV. Please, Please Review the Title to Your Assets to Avoid Probate

We continue to see errors in the title to assets, which could lead a decedent's Will into probate court after a death. Be certain that you have actually named beneficiaries of your life insurance and retirement plans. Be sure that all other assets (unless planned otherwise) are titled in your Family Trust.

We send our best wishes to all of you.

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