

**Steve Leimberg's Estate Planning
Email Newsletter Archive Message #2840**

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Subject: Joy Matak, Sandra D. Glazier & Martin M. Shenkman: An Estate Planning Six-Part Series for Late 2020, Part 1 - What Planners Should Be Doing with Their Clients NOW

“What follows in this newsletter series is a discussion of a wide range of planning considerations in this challenging planning environment. In this first installment, we discuss:

- 1. How the current planning environment has affected valuations.*
- 2. Opportunities to set up the plan now but wait to complete until after the election results are known.*
- 3. Variations on Domestic Asset Protection Trusts to preserve access.*
- 4. An easy solution: Refinancing intra-family loans or making new low interest intra-family loans.*

We look forward to presenting you with our next installments which will explore other opportunities for planning before year-end.”

Joy Matak, JD, LLM, Sandra D. Glazier, Esq. and Martin M. Shenkman, Esq. provide members with important and timely commentary in the form of a six-part series, Part 1 of which is a discussion of a wide range of planning considerations in this challenging planning environment.¹

Joy Matak, JD, LLM is a Partner at **Sax** and Head of the firm’s **Trust and Estate Practice**. She has more than 20 years of diversified experience as a wealth transfer strategist with an extensive background in recommending and implementing advantageous tax strategies for multi-generational wealth families, owners of closely-held businesses, and high-net-worth individuals including complex trust and estate planning. Joy provides clients with wealth transfer strategy planning to accomplish estate and business succession goals. She also performs tax compliance including gift tax, estate tax, and income tax returns for trusts and estates as well as consulting services related to generation skipping including transfer tax planning, asset protection, life insurance structuring, and post-mortem planning.

Joy presents at numerous events on topics relevant to wealth transfer strategists including engagements for the ABA Real Property, Trust and Estate Law Section; Wealth Management Magazine; the Estate Planning Council of Northern New Jersey; and the Society of Financial Service Professionals. Joy has authored and co-authored articles for the *Tax Management Estates, Gifts and Trusts (BNA) Journal*; Leimberg Information Services, Inc. (LISI); and *Estate Planning Review The CCH Journal*, among others, on a variety of topics including wealth transfer strategies, income taxation of trusts and estates, and business succession planning. Joy recently co-authored a book on the new tax reform law entitled *Estate Planning: Estate, Tax and Other Planning after the Tax Cuts and Jobs Act of 2017*.

Sandra D. Glazier, Esq., is an equity shareholder at **Lipson Neilson, P.C.**, in its Bloomfield Hills, MI office. She was also the 2019 recipient of Bloomberg Tax's Estates, Gifts and Trusts Tax Contributor of the Year Award and Trusts & Estates Magazines Authors Thought Leadership Award and has been awarded an AEP designation by the National Association of Estate Planners and Councils. Sandra concentrates her practice in the areas of estate planning and administration, probate litigation and family law.

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Here is their commentary:

EXECUTIVE SUMMARY:

Practitioners may still wish to encourage clients to consider estate and asset protection planning aggressively before the end of 2020. While we can now expect a changing of the guard at the White House and retention by the Democrats of the House of Representatives, control of the Senate is still unclear, with two seats heading to a runoff in Georgia.

Some commentators appear to believe that, regardless of which party winds up controlling the Senate, at least some adverse change in the

nation's tax laws may be enacted as early as the beginning of next year. It is possible for tax changes to be made retroactively effective to January 1, 2021 if the Democrats win both seats in the Georgia runoff elections.ⁱⁱ The level of Federal deficits caused by the COVID 19 pandemic may mean increases in taxes for many regardless of which party wins next month.

Practitioners need to be alert to possible broad changes to the wealth transfer laws and factor them into any planning that might still be completed before the end of the year. By way of example, we would suggest that practitioners consider the following:

- Caution clients as to the uncertainty of the election and even after the election is known the uncertainty over what tax legislation might be enacted and the possible effective dates of such legislation. Clients could be forewarned that all the planning efforts may be for naught and might even leave them in a position that is less favorable, depending on political developments and future legislation, than had they done nothing. It is also important to discuss with clients that regardless of the outcome of the Georgia runoff election, Congressional elections will occur in 2022, another Presidential election in 2024 and the exemption is to be reduced significantly in 2026 if congress does nothing. So, especially if planning has already begun, there may be a reason to conclude it regardless of the results of the Georgia runoff elections.
- Some clients will want the ability to unravel a plan if the Georgia runoff elections are not both taken by the Democrats. This might be done by including a disclaimer provision in a trust document and making gifts to the trust.ⁱⁱⁱ Another option is to make a gift to a QTIP'able trust and determining by the extended due date for a 2020 gift tax return, October 15, 2020, whether or not to elect QTIP treatment.
- Flexibility, to the extent possible and practical, may be the key to minimizing the potential for unhappy clients who transfer substantial wealth to irrevocable trusts and then regret the inflexibility the plan affords.
- Preserving access to assets transferred. There are a myriad of ways to accomplish this, some of which are discussed below.

The potential for harsh tax increases described may create a sense of urgency for some clients, but it also suggests that the application of the techniques involved may have to be uniquely different.

COMMENT:

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6. Opportunities to set up the plan now but wait to complete until after the election results are known.
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Valuations in the Current Environment

The current planning environment exhibits a number of unique characteristics which may each influence the planning mechanisms used and the application of those techniques. The intersection of historically low interest rates, artificially depressed asset values (for some assets) and very high federal estate and gift tax exclusion rates (\$11.58 million per taxpayer^{iv}) make this the perfect time to plan.

In these times of great market volatility and economic uncertainty, business valuations have been impacted. At the time of this writing stock market indices have reached all-time highs. Other stock prices remain low and have not fully recovered from the impact of COVID-19 (some may never recover). The impact of COVID-19 on valuations is incredibly unequal. Businesses that have benefited from sheltering in place, increased concerns over disinfecting, etc. have burgeoned in value. Other businesses have dropped in value and many have simply closed their doors.

Practitioners need to have an understanding as to how the current environment has impacted the particular asset in question. Generalizations as to valuation and future value may be more dangerous than ever before.

How might COVID-19 impact the valuation of closely held businesses? Valuation experts often start by assessing changes in actual and expected revenues and cash flow. For many industries and businesses, revenues and cash flows have plummeted, and there is great uncertainty about the depth and length of the downturn, and, subsequently, the speed and degree of the recovery. These sudden drops in economic activity and low interest rates are likely to be relatively short-lived, allowing taxpayers to transfer assets at a lower gift tax value today than the asset may be worth in six months or a year from now. Conversely, businesses that received loans that are forgiven under the Paycheck Protection Program, may show artificially inflated income in 2020, for portions of the loan subject to forgiveness.^v

Other current impacts may follow essential/non-essential business classifications. Future impacts may vary if changes in behavior occur as a result of COVID.^{vi} In many cases, blockage discounts may be greater today vs. pre- COVID on account of factors including volatility, overall market liquidity, etc.

Examples of Essential vs. Non-Essential Businesses

Essential

- Medical, healthcare
- Telecommunications
- Information technology systems
- Defense
- Food and agriculture
- Transportation systems
- Critical manufacturing
- Energy and utilities
- Financial services
- Government facilities
- Emergency services, law enforcement
- Water and wastewater
- Public works
- Essential retail (e.g., grocery stores, pharmacies)

Non-Essential

- Travel
- Leisure
- Most brick and mortar retail
- Many restaurants / bars
- Entertainment venues / live events
- Discretionary product manufacturing
- Casinos
- Fitness centers
- Shopping malls
- Amusement parks, carnivals, water parks, and bowling alleys
- Barbershops, hair salons, tattoo and piercing parlors, and certain other personal care services

All of that said, the time is now for obtaining a valuation of hard-to-value assets that will be valid for transfers made before the end of the year. Most valuation professionals are already overwhelmed with year-end planning projects and it will only get more difficult to get projections of value for closely held and other hard-to-value assets as we get closer to December 31.

A Biden presidency would need a majority in Congress with an appetite to raise taxes in order to make substantial changes to the tax code. However, President Biden would not need Congressional support to re-introduce regulations that restrict valuation discounts. Any client interested in making transfers of fractional interests in closely held businesses may want to move these assets before the end of the year while discounts are still available to reduce the tax value of hard-to-value assets.

Consider Teeing Up the Plan Now

Some clients are still reluctant to plan even as the year is winding down. Human nature and procrastination are not going to change now. For these clients, one might consider creating and funding an irrevocable trust with a moderate amount of cash or other assets so that a GST exempt, grantor trust exists and may be grandfathered from further legislation. Clients might take the risk that any tax change won't be retroactive so that they might add assets next year depending on the runoff results. Alternatively, a client may be able to use an older trust that had been funded in a prior year. For

example, for clients hesitant to shift additional assets, allocating GST exemption to old irrevocable life insurance or other trusts, and perhaps decanting them into better trusts, may provide benefit without committing to additional asset transfers. If tax law changes are proposed but not retroactive perhaps those trusts can be added to next year.

Documentation to complete a transfer of private equity, or an instruction letter to wire securities, can be prepared now so that the plan can be quickly implemented if and when the results of the Georgia runoff elections are known, or for worse procrastinators, when there is a change in tax law proposed.

Similarly, if the transfer involves private equity, the client may consummate a note sale now, and then gift the notes at some later point with draft forms of documentation prepared, but held in abeyance and unsigned to cancel the note if later desired. These types of steps might facilitate funding the trust with some of the intended assets quickly once the results of the election are known. Arguably, a client may even be able to wait until after a more definitive tax proposal from the victors is released. From a practical perspective, with the crush of work that many practitioners may be under as this year continues to wind to a close, taking steps now may prove to be a prudent approach in order to facilitate completion of the transaction before year-end.

Another approach, and both can be used, is to “bake in” the possibility of unravelling the planning done with the benefit of hindsight. There are several ways that this might be accomplished.

A provision for a disclaimer, described in Code Sec. 2518, might be integrated into a trust instrument granting the trustee or a named beneficiary the right to disclaim transfers to a trust on behalf of all beneficiaries so that the assets revert back to the donor.^{vii} If a trustee is to be provided the right to disclaim, that should be permitted under state law, the disclaimer should be expressly permitted, and the provisions should expressly permit the trustee to exercise the power without regard to the trustee’s fiduciary duties.^{viii}

Sample Clause: *“Any beneficiary of any trust created hereunder, in addition to any rights conferred on him or her by the law governing the validity, construction and effect of this instrument, is authorized at any time*

*within nine (9) months after the date of this instrument, and with respect to any additional property placed in trust hereunder within nine (9) months after such addition, to renounce or disclaim, in whole or in part or with reference to specific amounts, parts, fractional shares or assets, any interest, right, privilege, or power granted to that person by this instrument. Any such renunciation or disclaimer shall be made by an acknowledged, written instrument executed by that person or by his or her conservator(s), guardian(s), executor(s), administrator(s) or other personal representative, delivered to the Trustee and filed with an appropriate court or judicial office. If such renunciation or disclaimer is made by *Specified Beneficiary Name, who shall be treated as the Principal Beneficiary of the Lifetime Trust hereunder, any property disclaimed by such renunciation or disclaimer shall revert and be retransferred, reconveyed and repaid over to the person (the "donor") who made such transfer to such trust."*^{ix}

Treas. Reg. Sec. 25.2518-1(b) explains that upon execution of a qualified disclaimer, the disclaimed interest in property is treated "as if it had never been transferred to the person making the qualified disclaimer."^x The practical effect is that where a transfer is made to an irrevocable trust that provides for a reversion to the grantor, or, perhaps better, over to a trust created by the grantor, such that the transfer would then be treated as incomplete for gift tax purposes (a so-called "Incomplete Gift Trust,") in the event of a disclaimer, no taxable gift will be deemed to have been made in the event of any such disclaimer.^{xi}

An even bolder (but potentially risky) plan might be to provide that the named minor beneficiary of the trust could make a qualified disclaimer, on behalf of the trust, pursuant to Code Sec. 2518, as the minor would have nine months from his or her 21st birthday to make the disclaimer.

As another possible approach, a donor may wish to invoke the unlimited marital deduction by making a gift to a trust qualifying for an inter vivos QTIP election, as described in Code Sec. 2523(f):

1. The trust must grant to the donee spouse a qualifying income interest for life; and
2. The donor must make a timely QTIP election on a timely filed gift tax return.

To the extent that the election is made, no gift tax will be due (and no lifetime exemption used), assuming the spouse who is the beneficiary is a US citizen. On the other hand, to the extent that the donor fails to make a timely election as to all or part of the contribution to the trust, exemption will be used and, in effect, a so-called Spousal Lifetime Access Trust (SLAT) will have been created as to that part of the trust.^{xii}

This presents a unique opportunity in this time of great uncertainty. Arguably, the client could consummate a large gift in 2020 to a “QTIP-able” trust and then evaluate throughout the better part of 2021, until the extended filing date for the 2020 gift tax return (October 15, 2021), whether or not the gift or any part of it should, in fact, use exemption. The donor might consider using a formula QTIP election which fails to make the QTIP election as to the amount of the donor’s remaining exclusion available in 2020.

It's advisable for the estate planning attorney to work closely with the gift tax return preparer, financial advisors, and other professionals to ensure adherence to the planning. Lack of consistency and failure to make timely elections that specifically identify the portion of the transfer subject to the QTIP can adversely impact this type of planning.

Providing Access

Assuring that a client that might need access to assets transferred to a trust has reasonable access may be a critical prerequisite to the client proceeding with the planning. The following discussions review several of the ways in which practitioners might assist in providing potential access to assets transferred out of the estate. The discussion does not address using preferred interests that are not compliant with Section 2701 to secure exemption while retaining distributions on the preferred interest.

Variations of Domestic Asset Protection Trusts (“DAPTs”) May Be Vital for Moderate Wealth Clients to Use Exemption in 2020

Considering the substantial amount that some clients will wish to transfer to use currently high exemption amounts, may require careful attention to preserving access to those funds. Modern trust planning techniques provide an array of options to permit a client to benefit from assets transferred to completed gift trusts that can use exemption. These include:

DAPTs,^{xiii} hybrid-DAPTs where someone in a non-fiduciary capacity can add the grantor as a beneficiary, special powers of appointment to direct a trustee to make a distribution to the grantor,^{xiv} special power of appointment trusts (“SPATs”), variations of non-reciprocal SLATs, loan powers, floating spouse-clauses, etc. The number of states permitting self-settled trusts has grown steadily since Alaska enacted the first statute and now numbers 19.^{xv}

If clients have the potential to have access to the assets transferred, there may be fewer impediments for the client to proceed with planning in light of the risks posed by a change in the law relating to estate tax. However, practitioners should advise clients living in non-DAPT jurisdictions that this may come with increased risk of creditors reaching the assets in the trust or the IRS arguing for estate tax inclusion. Other than the cost of the planning, there may be less substantive downsides of planning now versus waiting and facing a potentially dramatically more limited planning regime. In fact, although effective estate tax planning always requires the client to give up certain access to assets^{xvi}, these strategies may nonetheless benefit him or her, as well as his or her family. The need to give up access in order to obtain tax savings may be something many moderate wealth clients have viewed quite differently with the current high exemptions; however, it might be appropriate to reexamine that perspective.

The use of self-settled domestic asset protection trusts (“DAPTs”), or variations of DAPTs, to provide clients access to the large wealth that must be transferred to secure some portion, or all, of the current large exemptions may be important to 2020 planning for certain clients.^{xvii} At the same time, there seems to be concern among some practitioners about the efficacy of this technique. Practitioners need to understand the issues to guide clients to make informed decisions about the use of DAPTs and variants, but to also give clients the comfort level to proceed with planning that could prove valuable.

Self-settled DAPTs may be an important option for moderate wealth clients in the late 2020 planning environment. Access to assets to be transferred in order to use the current large exemptions may be critical for many clients other than some UHNW (ultra-high net worth) clients. Many single clients, and even many married clients, will want or insist on being able to access the assets transferred should the need arise. With historically high exemptions, very large transfers (relative to the net worth of moderate

wealth clients - perhaps, defined as those having estates between \$5 million to \$40 million) are necessary to make a meaningful impact in securing as much of the large exemption as feasible before a possible tax law change (whether after the election or later). A more quantitative approach would be to evaluate the client's budget and use financial modeling to determine how much wealth can be retained and how much can reasonably be transferred.

Will assets transferred to a DAPT be excluded from the client's estate thereby having the transfer tax planning goals for the plan succeed? A DAPT formed in a DAPT jurisdiction may afford this result.^{xviii} Now nineteen states protect self-settled trusts from claims of the grantor's creditors. The issue seems to be: Does this work in other non-DAPT states? It's not certain, but perhaps if all formalities are adhered to, e.g., all persons and assets involved are in a "DAPT" state, it should succeed. The result on the continuum in between (i.e., where there are some ties to the home non-DAPT state) is less clear. If the DAPT results in creditor protection (because it is by recognized in both the state of creation and the state in which the donor resides as being excluded from the claims of creditors of the donor), then the trust should be excluded from the grantor's gross estate if the gift to the trust is complete.^{xix}

Consider Case Law in Formulating a DAPT Plan

When evaluating the possible use of a DAPT, practitioners should consider the *Wacker* case.^{xx} While some commentators concluded that DAPTs are no longer viable post-*Wacker*, many practitioners believe that the *Wacker* case was a bad facts case that does not inhibit the use of DAPTs at all, although alternative approaches and structures to lessen possible risks appear to be more commonly used. Others view the *Wacker* case as quite limited and that it does nothing to change the risks of the use of DAPTs even by those residing in non-DAPT jurisdictions. Rather, they view *Wacker* as a limited case addressing jurisdiction and another warning that no type of trust, self-settled or otherwise, can protect against a fraudulent conveyance.^{xxi}

In *Wacker*, both the Montana and the U.S. Bankruptcy Courts issued default judgments, including against the trust that purported to be an Alaska trust, holding that the transfers to the trust were fraudulent. The trustee brought an action in Alaska seeking to set aside the Montana and

bankruptcy court judgments, arguing that Alaska had exclusive jurisdiction on matters involving transfers to Alaska self-settled trusts.

Wacker is a narrow ruling that Alaska could not mandate that exclusive jurisdiction rests in Alaska where a fraudulent conveyance to an Alaska DAPT was found to have occurred by the courts of another jurisdiction. *Wacker* did not invalidate self-settled trusts created in Alaska. Indeed, although courts in other jurisdictions entered a default judgment on fraudulent transfer allegations, the viability of Alaska self-settled trusts to shield trust assets from the claims of the grantor's creditors was not addressed.

Planning Post-*Wacker* has evolved. Even DAPT proponents seem to suggest a wide array of variants of the traditional DAPT technique to provide more security, such as increased attention to hybrid-DAPTs and special power of appointment trusts ("SPATs"). But practitioners, even in the waning days of 2020, can take proactive steps to corroborate that the trust and transfer to it are not fraudulent conveyances, to differentiate a plan from *Wacker* and other bad-fact DAPT cases. These might include lien and judgment searches, other due diligence steps, having the transferor sign a solvency affidavit (whether or not state law requires it), forecasts by the client's wealth adviser demonstrating no anticipated need to access the DAPT assets, etc. Different requirements may be warranted in late 2020 in light of the relatively large percentages of wealth some clients are transferring in order to use more of their large temporary exemptions.

Additional considerations may include what life and long-term care coverage is in place pre-transfer. Should a large personal excess liability policy (umbrella) be acquired before a transfer? Should broader than traditional lien and judgment searches be obtained?

In a more recent case, a bankruptcy Judge found that a pre-existing asset protection trust, formed in the Cook Islands and moved to Belize, was subject to Florida law and not protected from the creditors of a Florida resident who was the grantor and beneficiary.^{xxii} This case might raise concern that a non-DAPT state resident's creation of a DAPT in a DAPT jurisdiction may be tainted as governed by his or her home state laws. However, in *Rensin*, the facts of the debtor's circumstances were

egregious. In another recent case, the Tax Court appears to have respected a foreign trust.^{xxiii}

Hybrid-DAPT

To address the concern that some practitioners have over the use of DAPTs by clients in non-DAPT jurisdictions, the hybrid DAPT has received increased attention. This is a potentially-DAPT trust in which the descendants of the grantor's grandparents (which obviously would include the grantor) can be added in as beneficiaries in the discretion of a person named to act in a non-fiduciary capacity. But when someone holds the power to add a beneficiary, the DAPT could be characterized as a grantor trust which may not be desirable in some instances. Practically, what this might mean, is a combination of various trusts (grantor and non-grantor, as well as other characteristics) tailored to the particular client's situation. If a client is concerned that a democratic win in the Georgia runoff elections could lead to the enactment of provisions similar to those proposed by Senator Sanders, the client might now consider creating or maintaining a grantor trust that might benefit from grandfathered treatment.

The power to add the grantor as a beneficiary could be made conditional by time (e.g., only after 10 years and one day (which might address issues raised by Bankruptcy Code 548(e)^{xxiv}). Another limitation some practitioners incorporate into DAPTs is that the grantor can only be a beneficiary when not married. While married the grantor can benefit through a spouse and may have no need to be a beneficiary, and hence no need to accept whatever incremental risk a DAPT might create. While many practitioners believe that the hybrid-DAPT will succeed, there is no law specifically on point. That might itself be an indication of success from an asset protection perspective. Unfortunately, there may yet be cause for some concern. A New York case suggests that a hybrid-DAPT may not succeed if the person, such a Trust Protector, who has the power to add the grantor as a beneficiary is acting under a fiduciary duty.^{xxv} Because a self-settled trust is one from which the trustee may or must make distributions to the grantor, some practitioners might opt to structure a hybrid-DAPT so that the person who can add the grantor is not acting under a fiduciary duty.^{xxvi}

Special Power of Appointment Trust ("SPAT")

Another approach is to permit a person named in a non-fiduciary capacity to direct the trustee to make a distribution to the grantor. In this way, the trust is not self-settled (which is the touchstone for attachment in many jurisdictions). If the power holder will not be an adverse party, the trust will be a grantor trust, under Sections 676 and 677.^{xxvii} If the trust is structured so as not to be a grantor trust, loan provisions may provide a means of access before turning on DAPT status and without triggering grantor trust status. But if the loan may be made without the requirement of adequate security or adequate interest, grantor trust status will also ensue. Indeed, loans to the grantor from a trust, regardless of the terms of the loan, may cause the trust to be taxed as a grantor trust under Section 675(3).^{xxviii}

Another consideration may be to draft limitations into the governing instrument. For example, consider including a provision that no distributions can be made to the grantor for ten years and one day after transfers are made to the trust to address the rights of a bankruptcy trustee to disavow a self-settled trust under the Bankruptcy Code.^{xxix} Some practitioners provide that the grantor cannot be added or appointed to be a beneficiary unless there is a divorce or death of a spouse or an individual cannot be added or appointed to be a beneficiary unless they are married to the grantor at the time the power of appointment is exercised.

If the trust is drafted as a third-party trust (that is, one not created by any beneficiary), and not a DAPT, but a power of appointment (“POA”) is provided to a senior family member, that POA can be exercised in favor of an appointment to a trust that includes the original trust’s settlor/grantor. That may not be characterized as a DAPT because the exercise of a POA probably will characterize the power holder, and not the initial grantor, as the transferor, especially if it is accomplished by use of a general power of appointment.

The opinions of well-known practitioners vary across a wide spectrum. Some say from, on one extreme, DAPTs do not work so, therefore, they use only foreign asset protection trusts (“FAPTs”) to achieve these goals. On the other extreme, some practitioners believe that DAPTs do work and the dearth of significant cases that do not involve bad facts suggests that most DAPT challenges either do not succeed or settle favorably. Still other practitioners express considerable discomfort with using FAPTs and prefer variations of DAPTs. Even amongst DAPT naysayers, it seems that many agree that if the grantor is domiciled in a DAPT jurisdiction that the DAPT is more likely to succeed. Since the number of jurisdictions recognizing

DAPTs has grown steadily, this creates more opportunities for use of this technique (even amongst practitioners who were historically leery of DAPTs).

Mix n' Match

Using a combination of SLATs, DAPTs, Hybrid-DAPTs and/or SPATs may provide a more flexible approach to accomplish client goals while at the same time differentiating what might have otherwise included a more basic non-reciprocal SLAT plan. With so little time left in the 2020 planning year, having time between the creation and funding of each of the non-reciprocal trusts may not be feasible. So, if one spouse creates a DAPT and the other a SLAT, etc. the DAPT may not only enhance access to trust assets, but is arguably a significant difference from the SLAT the other spouse created.

Substitution of Lower Interest Loan for Higher Interest Older Loan

There are even some planning opportunities for the most reluctant of clients who do not have any appetite for making additional wealth transfers before year-end.

The current historic low interest rates have created opportunities for some clients to substitute a lower interest note in place of an older high interest note. For example, parent sold assets to a trust several years ago in September 2015 when the required interest rate was 2.64%; in October 2020, the long-term rate was 1.12%, and the December rate is a bit higher at 1.31%. If a new note at the new rate could be substituted for the old note at the old rate, a substantial reduction in leakage back into the parent's estate could be achieved. Practitioners considering the array of planning options available to clients should evaluate the pros and cons of substituting low interest notes. The effects can be more substantial than the reduction of leakage. Assume that the parent had sold a 20% minority interest in a family business to a grantor trust in 2015 but no further sales occurred because of the concerns about cash flow from the enterprise to shareholders so that the trust could fund current note interest payments. The reduction in interest rate on the old note might also provide sufficient latitude to support a sale of further equity interests to the trust.

Consideration should be given to the documentation advisable for such a transaction. In some instances, practitioners may merely swap a new note for an old note. If the original loan transaction were merely that of a parent advancing funds at the mandated rate to a child, that might suffice. But practitioners should evaluate the overall transaction to identify what documentation and steps might be necessary to properly effectuate a note substitution. Assume, for example, that the original note arose from a sale by a parent of family business interests to a grantor trust. The following documentation and steps might be considered:

- Existing Note. The prerequisite to substituting a lower interest note is that the existing note can be prepaid at any time without penalty. So the first step is to confirm that the note can be prepaid at any time without penalty. If the original note incorporated restrictions on prepayment those must be resolved before proceeding. A sample provision permitting prepayment might read as follows: “Optional Prepayment. This Note may be prepaid in whole or in part at any time without premium or penalty. All payments made hereunder shall be applied first to the payment of unpaid interest under this Note and, second, to the unpaid principal amount of this Note.”
- Direction Letter. If the trust involved in the initial sale has a directed trustee then the investment director should provide the directed trustee a direction letter regarding the substitution and direct the trustee to execute documents relevant to the transaction.
- New Note. A new promissory note, revised for the changes made regarding the substitution, needs to be prepared and signed as part of the substitution. There may be no changes other than the interest rate. If the maturity of the loan is shortened (see discussion below) the date would change as well.
- Modification of Pledge and Escrow Agreement. If the original note arose from the sale of assets by the parent to the grantor trust there may have been a pledge and/or escrow agreement in the original transaction securing the parent/seller’s interests in the note. If so, then consider having all parties to that agreement sign a modification agreeing to the substitution of the original note for the new note being prepared. Such a document should address whatever prerequisites to a modification of the note are contained in the original pledge and escrow agreements. If this is not properly addressed the presumed innocent substitution of a note might constitute a default under the original transaction documents. That could be problematic if the IRS

challenged the transaction and the taxpayer themselves triggered a default and it went unnoticed.

- Novation Agreement. A novation agreement could be signed by both the maker of the note as well as the lender, and could confirm the agreement on cancellation of the original note.
- Other Documents. Be alert for other documentation or actions that might be necessary based on the nuances of the original transaction giving rise to the original note to finalize the substitution of the promissory note between the parties.

While the positive results are indisputable, there remains some uncertainty as to the tax results in some instances. The substitution of a lower interest note arguably should not have any adverse tax consequences. However, bear in mind that there is little actual law on point to support the tax-free consequences of this type of transaction. The IRS may argue that transaction triggers a gift tax on the grounds that the refinance of the original note at a lower interest rate increased the value of the trust without any economic benefit to the lender/grantor.

One theory to negate such an IRS challenge is that the current higher interest note, and the new lower interest note, are both worth their face value. While the IRS might argue that the existing higher interest note should be valued at a premium, the contrary argument to that is that since the old note can be repaid at any time there can be no premium as the higher interest rate has no assurance. This argument could be advocated (but not assured to succeed) to negate a challenge by the IRS that there was a gift tax consequence to the transaction. The above position might be supported by having an independent appraisal firm value the old note at its face value on the basis that no one would pay a premium for a note that is pre-payable at any time without penalty. The commercial analogy to this is that the premium on a callable bond with a higher than market interest rate will reflect that call feature. It is not clear, however, that any taxpayer has actually gone to the lengths to obtain an appraisal for this purpose.

There may, according to some views, be an advantage from the perspective of deflecting a gift tax challenge by the IRS if the lender receives something in return for agreeing to the reduction in interest rate. While this should not be necessary as long as the note permits prepayment without penalty, the argument might be that if the lender received a shorter term, additional principal payment, additional collateral, or some other

modification of value to the lender, that such value was consideration for the lowering of the interest rate. There is no case law or other authority supporting this suggestion or the possible IRS challenge.

If the borrower in the note substitution transaction is a grantor trust there should not be any income tax consequences as the transaction is with a disregarded taxpayer. Obviously, if there was a basis to challenge the grantor trust status of the trust that might negate the position of no negative income tax implication. If not, i.e., if the trust borrower is a non-grantor trust (e.g. the parent who consummated the original note sale transaction has subsequently died, or otherwise turned off grantor trust status) then consider the potential income tax consequences of the note substitution. If the transaction is with a non-grantor trust could a loss be realized on the substitution? While an argument might be advocated that the transaction might generate a loss for income tax purposes, it would seem that such a loss would, if it really occurred, be unavailable because of the related party rules.^{xxx}

Conclusion

It is prudent for practitioners to review the pros/cons of continued 2020 planning in light of the current political environment. In doing so, inform and educate clients as to the unique nuances of the current late 2020 planning environment, and the changes that may be in the offing (or not). The potential for massive tax changes is unpredictable but yet vital for many clients to consider, so that the client might consider taking proactive steps now. In this environment there are a range of planning considerations that affect how practitioners might practice, including estate tax minimization planning, income tax planning and more.

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

Joy Matak

Sandra Glazier

Martin Shenkman

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CITATIONS:

ⁱ This newsletter is an adaption of a paper submitted to the Notre Dame Tax and Estate Planning Institute, which was an adaption of Martin M. Shenkman, Jonathan G. Blattmachr, Joy Matak, & Sandra D. Glazier, [Steve Leimberg's Estate Planning Email Newsletter #2745](#) 03-Sep-19, "Estate and Tax Planning Roadmap for 2019-2020."

ⁱⁱ Pension Benefit Guaranty Corporation v. R. A. Gray & Co., 467 U. S. 717 (1984); United States v. Carlton, 512 U.S. 26 (1994).

ⁱⁱⁱ Be sure to analyze the potential that a disclaimer by the trustee may constitute a breach of fiduciary duty subjecting the trustee to claims by the trust beneficiaries.

^{iv}The federal estate and gift and generation skipping transfer tax lifetime exemptions are currently set to increase to \$11.7 million on January 1,

2021, if no change in the exemption amounts is effectuated through congressional action.

^v See Rev. Rul. 2020-27.

^{vi} Acknowledgements to Empire Valuations and Management Planning, Inc.

^{vii} Acknowledgements to Interactive Legal software for the sample provision provided.

^{viii} Caution is recommended when granting the right to disclaim to the trustee, inasmuch as the exercise of such a disclaimer may open the fiduciary to claims of breach of duty by the beneficiaries.

^{ix} The sample provision is based on language contained in Interactive Legal drafting software and is presented with their permission.

^x Remember to check state disclaimer laws, as some require delivery to the probate register and/or a qualified fiduciary to be effective as a state qualified disclaimer.

^{xi} Acknowledgements to Jonathan Blattmachr, Esq. for some of these thoughts.

^{xii} Acknowledgement to Professor Jerome B. Hesch, Esq. and Alan S. Gassman, Esq. as noted in the above article.

^{xiii} Self-settled trust jurisdictions now include Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming. See: PLR 200944002. Under Section 6110(k), neither a private letter ruling (PLR) nor a national office technical advice memorandum may be cited or used as precedent, although they may prevent the imposition of certain tax penalties

^{xiv} O'Connor, Gans & Blattmachr, "SPATs: A Flexible Asset Protection Alternative to DAPTs," 46 Estate Planning 3 (Feb 2019). By definition, a SPAT is not a self-settled trust so that state statute (e.g., NY EPTL 7-3.1) that permit creditors of the trust's grantor to access that assets in the trust and precedent (e.g., Rev Rul 2004-64, *infra*) which may cause such a trust to be included in the gross estate of the grantor should not apply.

^{xv} Self-settled trust jurisdictions now include Alaska, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

^{xvi} See, e.g., Rev. Rul. 2004-64, 2004-27 I.R.B. 7.

^{xvii} For application of DAPTs to premarital planning, which has many similar concepts relevant to the discussion herein, see, Glazier, Shenkman and Gassman “DAPTs & Klabacka - At the Intersection of Estate Planning and Family Law,” [LISI Asset Protection Planning Newsletter #357](#) (February 1, 2018).

^{xviii} Alaska enacted AS 34.40.110 providing complete asset protection for a self-settled trust if the Grantor was not trying to defraud a known creditor (plus other requirements)

^{xix} See Rev. Rul. 76-103, 1976-1 CB 293 and Rev. Rul. 2004-64, 2004-2 CB 7.

^{xx} *Toni 1 Trust v. Wacker*, 2018 WL 1125033 (Alaska, Mar. 2, 2018).

^{xxi} Blattmachr, Blattmachr, Shenkman & Gassman on Toni 1 Trust v. Wacker - Reports of the Death of DAPTs for Non-DAPT Residents Is Exaggerated, [Steve Leimberg's Asset Protection Planning Email Newsletter #362](#), Mar. 18, 2018.

^{xxii} *In re Rensin*, 17-11834-EPK, 2019 WL 2004000 (Bankr. S.D. Fla. May 6, 2019).

^{xxiii} *Campbell v. Commr. of Internal Revenue*, 117 T.C.M. (CCH) 1018, 1 (Tax 2019).

^{xxiv} US Bankruptcy Code Section 548(e) provides that a transfer to a self-settled trust (or similar device) may be set aside if it occurred within ten years of the filing of the petition for bankruptcy and was made “with an actual intent to hinder, delay or defraud” a creditor. Blattmachr, Blattmachr, Shenkman & Gassman on Toni 1 Trust v. Wacker - Reports of the Death of DAPTs for Non-DAPT Residents Is Exaggerated, [Steve Leimberg's Asset Protection Planning Email Newsletter #362](#), Mar. 18, 2018.

^{xxv} Iannotti, 725 NYS 2d 866 (2001). Acknowledgements to Jonathan Blattmachr, Esq. for pointing out this issue and case.

^{xxvi} This might be accomplished by providing for a lifetime limited power of appointment.

^{xxvii} It may be feasible to create a non-grantor DAPT. *Makransky v. Comm.*, 321 F.2d 598 (3rd Cir. 1963). See also, Lipkind, Shenkman and Blattmachr, “How ING Trusts Can Offset Adverse Effects of Tax Law: Part I,” *Trusts & Estates*, Sept. 2018, p. 26; “How ING Trusts Can Offset Adverse Effects of Tax Law: Part II,” *Trusts & Estates*, Dec 2018, p.2.

^{xxviii} Section 675(3) provides in part, that a trust will be a grantor trust where “The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor.” Hence, it will be appropriate to have an independent trustee make the loan and to require adequate interest and security. It is not certain what constitutes either.

^{xxix} Section 548(e) of the United States Bankruptcy Code, which provides that assets transferred to a self-settled trust or similar device (whatever that means) are included in the bankrupt estate (for distribution to creditors) if transferred within ten years of the filing for bankruptcy if the transfer was intended to hinder, delay or defraud a creditor.

^{xxx} IRC Sec. 267.