WILMINGTON TRUST

MEMBER OF THE M&T FAMILY

What Does Gifting Under the Biden Administration Mean for Your Wealth Plan?

Prepare now for potential tax law changes

Alvina H. Lo

Chief Wealth Strategist

Key points

- As the Biden administration's impact on tax legislation is still uncertain, it may be more important than ever to revisit your planning
- With the potential for a considerably reduced federal gift tax exemption, now may be a good time to make significant gifts
- Barring any intervening legislation, the current exemption amount is slated to sunset on December 31, 2025

The Biden administration's impact on tax legislation is still uncertain. Therefore, it may be more important than ever to revisit your planning especially since tax legislation has the potential of being retroactive. For those who took a "wait and see" approach at year end, the time to evaluate and put a plan in place may be now.

Consider making significant gifts to take advantage of the disappearing gift tax exemption

For those whose assets are significant enough to have a taxable estate, planning may be even more important now. One result of the comprehensive tax reform enacted in 2017 was a significant increase in the gift, estate, and generation-skipping transfer (GST) tax exemption. Indexed for inflation, the amount exempt from federal gift and estate tax in 2022 is $12.06 million per person ($24.12 million for a married couple),[1] which means that you may give up to this amount during your lifetime, free of gift tax, with any unused amount applied against federal estate taxes at your death.

Barring any intervening legislation, the current exemption amount is slated to sunset on December 31, 2025, and effective January 1, 2026, the exemption reverts to $5 million per individual ($10 million for a married couple) as indexed for inflation.[1] However, President Biden has indicated an intent to further reduce the lifetime gift exemption and estate and GST exemption prior to the sunset.[1] With a drop in the gift exemption, high-net-worth individuals could lose more than 90% of their ability to efficiently transfer wealth if there is new legislation.

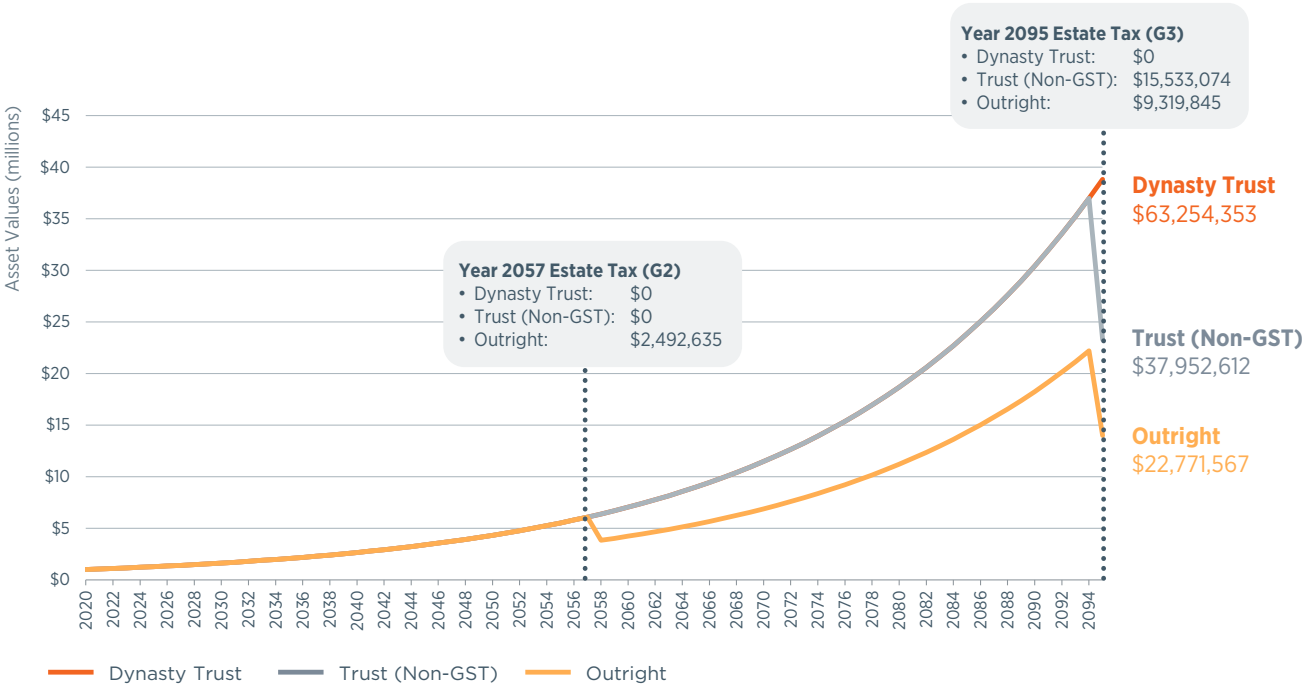
Consider creating a trust and gifting assets to it sooner rather than later

The earlier a gift is made, the more time it will have to grow outside of your estate, and this is particularly true where a large gift is made to a trust rather than outright. In addition to benefits of a trust such as professional management, tax mitigation, and creditor protection, a trust structured as a grantor trust could effectively allow the trust assets to grow income tax free, as all income tax obligations could be paid by the grantor. The grantor trust structure also benefits the grantor in that all payments for taxes further reduce the grantor's taxable estate and yet are not subject to gift tax.

Continued

Figure 1
Example of benefits of gifting to a dynasty trust

Assumptions: Initial investment of $1,000,000 | Net rate of return of 5% | Each generation holds assets for 37.5 years | Estate tax of 40%



This chart is for illustration purposes only and does not reflect the actual performance of any specific investment. The illustration is hypothetical and is intended solely to depict the benefits of a dynasty trust.

Source: Wilmington Trust Wealth Planning team.

If structured and administered properly, the trust may serve multiple generations with significant tax benefits. Using the dynasty trust as an example (see Figure 1), and based on the assumptions depicted, if you gift $1 million to this type of long-term trust, that gift could grow to almost three times its value in just two generations as compared to an outright gift.

Overcome common "roadblocks"

Although the inherent value of gifting is understood by many, the mental roadblock of parting with such significant assets can be daunting, and there are some strategies that can help you get past them. Like many, you may feel that you are being rushed into this decision and it may paralyze your ability to move forward. No one likes the feeling of being rushed. Here are three common roadblocks and strategies that may help you to get past them.

1. How can I maintain flexibility in a trust?

Consider a spousal lifetime access trust (SLAT). These trusts are designed to take advantage of the gift tax exemption while allowing a way for your spouse (as a beneficiary of the trust) to continue to enjoy the benefits of the trust now and in the future, if needed. For example, if a husband were to create a trust for the benefit of his wife and children, because his wife is a beneficiary of the trust, she may request a distribution of the funds from the trustee. The trustee may exercise its fiduciary responsibility and make the distribution to the wife, as beneficiary, assuming it is appropriate and in accordance with the terms of the trust. If the wife wishes to then later share that distribution from the trust with her husband or use the distribution for their joint benefit (e.g., making improvements to the family home), she may do so without negative gift tax consequences. In some cases, it may make sense for the family to have two trusts: one where

Continued

Perhaps the biggest roadblock for many is having to give up control over the trust assets. While an irrevocable trust, by its nature, necessitates some limits and restrictions over control, the directed trust structure allows for greater flexibility.

the husband creates a trust for the benefit of his wife and children, and one where the wife creates a trust for the benefit of her husband and children. This way, both spouses could potentially benefit from the trust assets should the need arise in the future. One thing to note is that these trusts must not be identical and need to contain enough variations so as not to run afoul of the "reciprocal trust doctrine."

Include a testamentary power of appointment. In the SLAT strategy described above, an additional feature than can offer further flexibility is a special power known as a "testamentary power of appointment." This would allow you to give your spouse a "second bite of the apple" because your spouse may, using this power in his/her will, redirect the trust assets to a pre-determined group of people or charity. For those who are concerned about deciding now about how their assets are to be distributed down the road, this is a good way to effectively delay that decision and allow your spouse to determine at a later time when the future becomes clearer.

Implement a directed trust. Perhaps the biggest roadblock for many is having to give up control over the trust assets. While an irrevocable trust, by its nature, necessitates some limits and restrictions over control, the directed trust structure allows for greater flexibility. A properly drafted directed trust under the right jurisdiction can allow traditional trustee responsibilities over distribution and investment decisions to remain with trusted family members, friends, or advisors.

Essentially, the directed trust splits fiduciary responsibilities, allowing you as the grantor of the trust to name your own investment advisor to manage the assets, while the trustee is responsible for other aspects of administering the trust. The trustee can't be held liable for the investment advisor's actions unless the trustee engages in willful misconduct related to the investment process. This structure is particularly beneficial for business owners who do not wish to divest the business interests held in a trust.

The directed trust feature can provide significant flexibility since it can be added to virtually any type of trust structure in Delaware. Delaware's directed trust law provides:

- Freedom to engage in estate planning or asset protection planning using illiquid assets, such as stock in the family business, real estate, or hedge fund/private equity investments, when a trustee may otherwise be reluctant to hold these types of assets
- Flexibility for a trusted advisor or family member to retain control over a trustee's investment or distribution decisions so that they can do what is best for the family/beneficiaries[2]

Generally, gone are the days where trusts were created and operated in a black box. Modern trust law and drafting have evolved to allow for the family to remain involved and provide flexibility for generations to come.

2. How do I know how much and what assets to gift to the trust?

It's one thing to talk about gifting in the abstract; it's quite another to make that a reality. One of the most common questions is: how much do I gift and what asset do I gift?

An experienced financial planner can help you answer this question by running detailed analyses and projections to quantify the impact of the gift against your future needs. A sustainability analysis is recommended to help determine how a gift that's removed from your balance sheet may impact your future cash flow and lifestyle needs. The sustainability analysis should also be stress tested to account for any future contingencies. Depending on your balance sheet and needs,

Continued

Generally, gone are the days where trusts were created and operated in a black box. Modern trust law and drafting have evolved to allow for the family to remain involved and ensure flexibility for generations to come.

gifting the maximum amount allowed under the current law might be too large a gift and could begin to erode your future cash flow or lifestyle needs. In that case, it may be wise to reverse engineer back to a more comfortable gifting amount.

3. I am still not sure and may need more time, what strategies may give me more flexibility?

While the likelihood of tax legislation changes is still yet to be seen, having a gifting strategy in place that is ready to be executed is critical in case of any swift legislative changes. Here are some strategies that may help you buy a little more time.

Gift cash or marketable securities now to lock in the exemption and include a "swap" power

Like many, your most valuable asset with the highest appreciation potential (and typically the ideal asset to gift) is often also a complex asset that is hard to value. Many of these assets are also levered where a transfer of ownership implicates credit which can be challenging to restructure. In these cases, there may not be enough time to properly value the asset and work through the mechanics involved for a quick gift. A potential strategy is to utilize a "swap" power in the trust. This type of power allows you to substitute assets of equal value in and out of the trust at a later time. For example, let's say you wish to make a gift of $12 million consisting of your business interests and you are concerned that you cannot do this quickly in case there is a swift change in legislation. In this case, you may instead make a gift of cash or marketable securities (that are readily valued) of $12 million into a trust now to lock in the use of the gifting exemption. Then, some time later in the year, you, as grantor of the trust, can exercise your swap power and exchange the business interests for the cash/marketable securities. The result: the business interest is held in the trust, and you have the cash/marketable securities back. If cash flow is an issue, many banking institutions may be able to provide a short-term lending facility to accommodate and bridge the timing gap. If structured and implemented correctly, this kind of swap will not have any negative tax consequences.

Issue a promissory note now and cancel the note later if gifting is desired

If you are still uncomfortable with making a sizable gift and want a little more time to consider before making the final decision, one strategy is to lend the asset that may be potentially gifted to your beneficiary (or a trust for his/her benefit) and receive a promissory note in return. Pending any news on legislative action (and assuming changes are not retroactive), you can simply forgive the note, hence making the effective date of the gift prior to any legislative changes.

What if this kind of gifting is just not for me; what else should I consider for my estate planning before the gift exemption disappears?

Do not forget the existing trusts you've created. You may already have an existing estate plan that includes trusts. Many of these older existing trusts may not have been created properly with the right allocation of GST exemption. In some cases, you may be able to apply the current GST exemption and "protect" these old trusts and make them effectively GST trusts. This would not require additional asset outlay from you. You're simply using up your exemption in a smart way. Before implementing this strategy, you will want to work with your wealth advisor and attorney to be sure that the existing trusts are in the proper form, and if not, determine whether a modification is possible.

Consider a GRAT if you don't want to use your gift exemption. If you do not wish or are not ready to use your gift exemption, there are other strategies to consider. In a low interest rate environment, a grantor retained annuity trust (GRAT) may be a valuable consideration. A GRAT is a popular strategy of transferring property that is expected

Continued

to appreciate in value to a trust in exchange for an annual payment (or annuity) for a term of years. The amount of the annuity is determined by the length of the trust, the value of the property transferred, and current interest rates. As of April 2022, this interest rate, also known as the 7520 rate, is 2.2% (up from the same time last year but still relatively low).[1]

The primary tax benefit of a GRAT is that any income or appreciation earned during the term, in excess of the stated interest rate, passes to the remainder beneficiaries (who are often children or family trusts) free of gift or estate tax. GRATs are a popular strategy because there is limited economic downside and you can effectively retain control of the property transferred. Moreover, GRATs may be designed (today's current tax law – as of 2022) to pay back to you the entire value of the property plus the stated interest amount without any gift tax consequences. (This technique is often referred to as a zeroed-out GRAT.)

Do not forget about your life insurance. There is often a mistaken notion that the death benefit from life insurance is tax free. While life insurance proceeds are income tax free, they are not estate tax free. In other words, life insurance owned outright by you is includable in your estate and subject to the estate tax. Many individuals have substantial life insurance policies, which may be structured incorrectly, as they are not held in a trust. This may be a good time to gift those policies into an irrevocable life insurance trust (ILIT) for the benefit of your family. If structured and administered properly, the death benefit received by the ILIT could be free of both income and estate taxes. The gift of certain policies can be a taxable gift, and this would be a good way to use the gift exemption without any additional cash outlay. Before implementing this strategy, it is important to work with your advisor to conduct a careful analysis of the nature of the insurance policies to see if this strategy is appropriate.

I already made year-end gifts, should I do more?

For those who created year-end trusts to take advantage of the 2021 gift exemption, note that the allowable exemption amount has increased by $360,000 per person (or $720,000 for a married couple) for this year. You may wish to gift this additional amount into a previously created trust in order to maximize the use of the remaining gift exemption in 2022. For many, a year-end gifting strategy included utilizing a SLAT. Given the potential of tax law changes later in the year, you may consider creating another SLAT where the beneficiary includes the other spouse and gift assets equal to any remaining gift exemption amount into the second SLAT. As previously discussed, care should be taken to ensure that the second SLAT does not contain the same terms as the first SLAT so that it runs afoul of the "reciprocal trust doctrine." The fact that the SLATs are created in different calendar years could be helpful in that regard.

Continued

Alvina H. Lo
Chief Wealth Strategist
Wilmington Trust, N.A.

212.415.0567
alo@wilmingtontrust.com

As part of the Wilmington Trust Emerald Family Office & Advisory team, Alvina is responsible for wealth planning, family office services, and thought leadership development for Wilmington Trust's Wealth Management division. She oversees a national team of wealth strategists, family office services professionals, and thought leaders, who together, serve as advisors to high-net-worth individuals and families, business owners, entrepreneurs, and foundations.

Alvina holds a bachelor's degree in civil engineering from the University of Virginia where she was a Thomas Jefferson Scholar. She received her JD from the University of Pennsylvania, where she was a member of the Law Review and Order of the Coif. She also holds a Professional Tax Certificate in Estate Planning from New York University School of Law.

Alvina is a Fellow of the American College of Trust and Estate Counsel (ACTEC), a highly selective group of peer-elected trust and estate attorneys in the U.S. and abroad. She has been named as a recipient of the 2021 Outstanding 50 Asian Americans in Business Award by the Asian American Business Development Center. She also has been recognized by Crain's New York Business as one of their Most Notable Women in Financial Advice in 2020. The honor recognizes leading women executives in New York City for their dedication to excellence in the financial industry and significant professional, civic, and philanthropic contributions. In addition, she was recognized as one of Worth's Groundbreakers 2020: 50 Women Changing the World.

[1] Source: www.irs.gov

[2] Source: https://delcode.delaware.gov/title12/c033/index.html

