THE ESTATE PLANNER

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SLATs OFFER AN ESTATE PLANNING SAFETY NET

Can multiple trusts be used to maximize the pass-through deduction?

Protecting the nest egg
Safeguard your assets with these protection strategies

Estate Planning Red Flag
You're splitting gifts with your spouse

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SLATs offer an estate planning safety net

By doubling the gift and estate tax exemption, the Tax Cuts and Jobs Act (TCJA) created a significant tax-saving opportunity for affluent families. Adjusted for inflation, the exemption amount currently stands at $11.4 million ($22.8 million for married couples filing jointly). However, this is a limited-time offer that expires at the end of 2025. Beginning in 2026, the exemption amount will revert to its pre-TCJA level of $5 million ($10 million for married couples), adjusted for inflation, barring further action from Congress.

Many people are taking advantage of the temporary increase by giving away substantial amounts of wealth gift-tax-free — either directly or in trust — during the next six-plus years, locking in the higher exemption amount. (But see "Should you be worried about a clawback?" on page 3.)

What if you're reluctant to give away substantial amounts of wealth now, for fear that you may need access to it down the road? One potential solution is a spousal lifetime access trust (SLAT). Under the right circumstances, a SLAT allows you to remove significant wealth from your estate tax-free while providing a safety net in the event your needs change in the future.

SLAT basics

A SLAT is an irrevocable trust that permits the trustee to make distributions to your spouse, during his or her lifetime, if a need arises. Typically, SLATs are designed to benefit your children or other heirs, while paying income to your spouse during his or her lifetime. You can make completed gifts to the trust, removing those assets from your estate. But you continue to have *indirect* access to the trust by virtue of your spouse's status as

a beneficiary. Usually, this is accomplished by appointing an independent trustee with full discretion to make distributions to your spouse.

SLATs must be designed carefully to ensure that they achieve your objectives and that the trust assets aren't included in your spouse's estate.

Handle with care

SLATs provide welcome flexibility in uncertain times, but they must be planned and drafted carefully to avoid potential pitfalls. For example, to ensure that the assets are removed from your estate, you shouldn't serve as trustee. It's possible to name your spouse as trustee, but be aware that, if you do, distributions from the trust generally will be limited to those necessary for his or her health, education, maintenance or support. The trust should also prohibit distributions that would satisfy *your* legal obligation of support to your spouse.

To avoid inclusion of trust assets in your spouse's estate, your gifts to the trust must be made with your separate property. This may require additional planning, especially if you live in a community property state. And after the trust is funded, it's critical to ensure that the trust assets aren't commingled with community property or marital assets.

It's important to keep in mind that a SLAT's benefits depend on indirect access to the trust through your spouse, so your marriage must be strong for this strategy to work. There's also a risk that you'll lose the safety net provided by a SLAT if your spouse predeceases you. One way to hedge your bets is to set up two SLATs: one created by you with your spouse as a beneficiary and one created by your spouse naming you as a beneficiary.

If you and your spouse each establish a SLAT, you'll need to plan carefully to avoid the reciprocal trust doctrine. Under that doctrine, if the IRS concludes that the two trusts are interrelated and place you and your spouse in about the same economic position as if you had each created a trust for your own benefit, it may undo the arrangement. In other words, the IRS may treat each trust as if the grantor had named him- or herself as a life beneficiary, thereby erasing the tax benefits. To avoid this outcome, the trusts' terms should be varied so that they're not substantially identical.

Best of both worlds?

With careful planning and a strong marriage, a SLAT may offer the best of both worlds: the ability to make the most of the increased exemption while retaining some access to your wealth. Contact your estate planning advisor for additional details. ■

Should you be worried about a clawback?

When contemplating large lifetime gifts to take advantage of the increased gift and estate tax exemption, one thing that gives people pause is the possibility of a "clawback." In other words, when the exemption reverts to its previous level in 2026, there's a concern that the IRS will attempt to impose estate taxes on the excess of any pre-2026 gifts over the post-2025 exemption amount.

The issue stems from the way estate taxes are calculated: First, prior taxable gifts are added back into your estate (at their date-of-gift values) and estate tax is computed on the total (based on the date-of-death exemption amount and tax rate). Next, the tax is reduced by any gift taxes previously paid. Fortunately, the IRS has issued proposed regulations that, assuming they're finalized as is, avoid this outcome. The proposed regulations would establish rules ensuring that, in calculations of estate taxes for decedents dying after 2025, the higher exemption amount will apply with respect to gifts made between 2018 and 2025.

Can multiple trusts be used to maximize the pass-through deduction?

The Tax Cuts and Jobs Act added Section 199A to the tax code, allowing owners of sole proprietorships and pass-through entities (partnerships, S corporations and LLCs) to deduct up to 20% of their qualified business income. Popularly known as the "pass-through" deduction, Sec. 199A offers valuable tax benefits to business owners, but these benefits may be reduced or eliminated if an owner's taxable income exceeds certain thresholds.

One potential strategy to qualify for the full deduction is to transfer portions of the business to several trusts for the benefit of your children or other heirs, each of whom has income below the applicable threshold. Recently finalized regulations prevent the use of multiple trusts as a tax avoidance device, but with careful planning there still may be opportunities to make the most of the pass-through deduction.

For purposes of the pass-through deduction, the taxable income threshold for a trust is the same as that for individuals.

Deduction limits

There are two important limits on the ability of higher-income taxpayers to take advantage of the pass-through deduction. First, owners of "specified service trades or businesses" (SSTBs) — such as health care providers, accounting and law firms, consulting firms, financial services firms, and brokers — are ineligible for the deduction. Second, the deduction is limited to the *greater* of 1) 50% of the owner's share of the business's W-2 wages, or 2) 25% of W-2 wages plus 2.5% of the original cost basis of qualified business assets.

Both limitations are gradually phased in beginning at taxable income of $160,700 ($321,400 for joint filers) and fully applicable when taxable income exceeds $210,700 ($421,400 for joint filers). So, for example, a single SSTB owner with taxable income over $210,700 is ineligible for the pass-through deduction. And a single non-SSTB owner at that income level is subject to the wage and asset limitations. If the business has no W-2 wages or qualified assets, the allowable deduction is zero.

On the other hand, an owner whose taxable income is below $160,700 ($321,400 for joint filers) is eligible for the full deduction regardless of the type of business or the extent of its wages or qualified assets.

The trust strategy

For purposes of the pass-through deduction, the taxable income threshold for a trust is the same as that for individuals. So, a trust that's taxed as a separate entity and has taxable income of $160,700 or less qualifies for the pass-through deduction even if it receives income from an SSTB or a business with no wages or qualified assets.

The IRS was concerned that business owners otherwise ineligible for the pass-through deduction would divide their businesses among several trusts, each with income under the threshold, to avoid the deduction limits. To discourage this strategy, final regulations issued in January 2019 contain an "anti-avoidance" provision: For purposes of the pass-through deduction, two or more trusts will be aggregated and treated as a single trust if 1) they have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and 2) a principal purpose for establishing such trusts (or contributing additional property to them) is to avoid federal income tax.

Since the anti-avoidance rule applies only to trusts with the same primary beneficiary or beneficiaries, it appears that one can maximize eligibility for the pass-through deduction by establishing a separate trust for each beneficiary.

Look at the big picture

Transferring business interests to trusts can maximize the pass-through deduction, but it may also raise a variety of other tax and nontax issues. For example, trusts are subject to income tax at the highest federal rate at much lower levels of taxable income ($12,750 in 2019). So, it's important to consider this strategy in the context of your overall tax and estate plan. But if your plan calls for business interests to be held in a trust taxed as a separate entity, it may be advantageous to establish a separate trust for each beneficiary. ▮

Protecting the nest egg

Safeguard your assets with these protection strategies

Sometimes the easiest and most basic plans of action can be the most effective. Take, for instance, asset protection. Offshore or domestic trusts can be effective vehicles for protecting wealth, but they can be complicated and costly. Let's review a few basic, yet effective, asset protection strategies.

4 asset protection strategies

One of the primary objectives of estate planning is protecting your assets from unreasonable creditors' claims or frivolous lawsuits. The reason is that you want to pass as much of your wealth to your family as possible.

The following four strategies involve transferring assets to another person or entity, or changing the way property is titled:

1. Buying liability insurance. For many people, insurance is the first line of defense against liability claims that expose their assets to risk. It includes personal or homeowner's liability insurance, as well as professional liability insurance for doctors, lawyers and other professionals who are common targets for lawsuits.

2. Making lifetime gifts. The most effective asset protection strategy may also be the simplest: giving your assets away to your children or other loved ones. After all, a creditor can't come after assets you don't own. The disadvantage of this approach, of course, is that you must relinquish control over the assets. But if you're comfortable parting with assets during your lifetime, gifts are a great way to place them beyond the reach of your creditors.

3. Using tenancy by the entirety. Many states permit married couples to hold their home or other real estate as "tenants by the entirety." This form of ownership protects assets against claims by either spouse's separate creditors. So, for example, it can be effective when one spouse is exposed to professional liability risks. It doesn't, however, protect couples against claims by their joint creditors. Tenancy by the entirety, if available, is a good option for people who aren't comfortable transferring title to their spouses.

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4. Including assets in retirement accounts. Qualified retirement plans — such as 401(k), 403(b), and 457 plans, as well as certain pension and profit-sharing plans — are excellent asset protection vehicles. Assets held in most qualified plans enjoy unlimited protection from creditors' claims — both in bankruptcy and outside of bankruptcy — under the Employee Retirement Income Security Act.

Stay on the right side of the law

Most states have fraudulent transfer laws, which prohibit you from transferring assets with the intent to hinder, delay or defraud any creditor, including a *probable* future creditor. Typically, these laws also prohibit "constructive fraud," which is when you transfer assets, without receiving reasonably equivalent value in exchange, and you're insolvent before or after the transfer.

To ensure that your asset protection efforts are successful, be sure that you're solvent before and after any transfer and that you transfer assets at a time when there are no actual or potential creditors' claims on the horizon.

Keep what's yours

Incorporating asset protection strategies into your estate plan is a smart move, and it can be accomplished using straightforward estate planning strategies. Contact your estate planning advisor before taking any action.

ESTATE PLANNING RED FLAG

You're splitting gifts with your spouse

The annual gift tax exclusion allows you to transfer up to $15,000 per beneficiary gift-tax-free, without tapping your lifetime gift and estate tax exemption. And you can double the exclusion to $30,000 per beneficiary if you elect to split the gifts with your spouse.

It's important to understand the rules surrounding gift-splitting to avoid unintended — and potentially costly — consequences. Common mistakes include:

Failing to make the election. To elect to split gifts, the donor must file a gift tax return and the nondonor must consent by checking a box on the return and signing it or, if a gift exceeds $30,000, filing his or her own gift tax return. Once you make the election, you must split *all* gifts to third parties for the year.

Splitting gifts with a noncitizen. To be eligible for gift-splitting, one spouse must be a U.S. citizen.

Divorcing and remarrying. To split gifts, you must be married at the time of the gift. You're ineligible for gift-splitting if you divorce and either spouse remarries during the calendar year in which the gift was made.

Gifting a future interest. Gift-splitting can be used only for present interests. So, a gift in trust qualifies only if the beneficiary receives a present interest — for example, by providing the beneficiary with so-called Crummey withdrawal rights.

Benefiting your spouse. Gift-splitting is ineffective if you make the gift to your spouse, rather than a third party; if you give your spouse a general power of appointment over the gifted property; or if your spouse is a potential beneficiary of the gift. For example, if you make a gift to a trust of which your spouse is a beneficiary, gift-splitting is prohibited unless the chances your spouse will benefit are extremely remote.

Be aware that, if you die within three years of splitting a gift, some of the tax benefits may be lost.

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