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SEPTEMBER 2020 CLIENT UPDATE

We hope that this letter finds you and your family healthy and safe. While we have all been impacted by the pandemic and how it has changed our economy and way of life at least for the time being, we hope that the personal consequences to you and your loved ones have been minimal.

We are writing this annual alert earlier in the year than usual to urge clients who are considering making gifts in the coming years to consider whether those gifts should be made in 2020 and asking all who are considering 2020 gifts to contact us ***as soon as practicable*** to explore the various planning options available while the $11,580,000 federal exemption remains in effect. ***Waiting until later in the year may waste the opportunity to maximize the potential benefits of the gifting program through careful planning.***

If President Trump is re-elected and the Republican party continues to hold a majority in the Senate and/or re-gains a majority in the House, it is likely the current law with regard to estate, gift and generation-skipping transfer ("GST") taxes will remain the same. This would mean maintaining the current $10,000,000 federal estate, gift and GST tax exemptions (indexed for inflation) through 2025. In fact, President Trump's campaign is proposing making his 2018 tax law changes to the estate, gift and GST taxes permanent so that these more generous tax laws do not revert back to prior levels in 2026 as scheduled under current law.

FEDERAL ESTATE, GIFT AND GST TAX RATES AND EXEMPTIONS 2017–2026

Year	Exemption	Rate
2017	$ 5,490,000	40%
2018	$11,180,000	40%
2019	$11,400,000	40%
2020	$11,580,000	40%
2021-2025	$11,580,000*	40%
2026	$ 5,490,000*	40%

* as indexed for inflation

On the other hand, a change in the composition of the Senate, especially if coupled with a Democratic Administration in the White House, almost guarantees changes to many tax laws. While we cannot be certain what a Biden Administration would seek to change in the federal tax laws, the Biden campaign has begun to discuss some proposed changes. As of the date this letter went to print, the Biden campaign has stated that, as President, Biden would seek to return estate, gift and GST taxes to their "historical norm" while also eliminating the step-up in basis for inherited assets.

There are no further specifics right now. For example, would a return to the "historical norm" mean reducing the current exemption amounts to the $5,000,000 level which was enacted under President Obama in 2012 and was the exemption until 2018 when it was increased by President Trump, or is Biden thinking further back in history and suggesting a return to the 2009 level of $3.5 million? Also unclear is whether a Biden White House would increase the rate of the estate tax, which is currently 40% but was 45% in 2009 and has been as high as 55% in recent memory. Finally, the potential elimination of the step-up in basis rules are not defined. This could be interpreted to mean a "carry over basis" regime in which heirs receive assets with the same tax basis as the decedent had in the assets, so when those assets are sold capital gains are determined using the decedent's basis. Or could it mean that all assets are treated as if sold on date of death and the estate must pay capital gains tax on appreciation in addition to the estate taxes due?

Should the Democrats win both Houses of Congress and the White House, it is possible that tax reform legislation could be introduced in early 2021 effective retroactively to January 1, 2021.

WHY GIFT DURING 2020?

For those clients who had already used most or all of their $5,000,000 gift tax exemption prior to the dramatic increase in the gift tax exemption to $10,000,000 (indexed for inflation), the increased exemption offers an opportunity to make additional gifts tax free and to exempt gifts from GST tax as well. For clients who have not yet used their lifetime gift exemptions, the increased exemption amounts make this an excellent time to consider making lifetime transfers.

When making gifting decisions, remember to consider capital gains and state tax implications:

- Connecticut has a separate state gift tax with an exemption of only $5,100,000 in 2020. This means that if a Connecticut resident who has not used a gift exemption in the past makes a $11,580,000 gift to take full advantage of the federal gift exemption available this year, a Connecticut gift tax of $717,600 will be due on the $6,480,000 difference between the federal and Connecticut exemptions. Note, however, that this tax can be avoided if the gift involves out-of-state real property or tangible personal property, since real property and tangible personal property located outside of Connecticut are not subject to Connecticut gift tax. Conversely, gifts by non-residents of real property and tangible personal property located in Connecticut are also subject to Connecticut's state gift tax.
- New York has no gift tax but has an estate tax with an exemption of only $5,850,000. This means a New York resident who has not used any gift exemption in the past can gift up to $11,580,000 during 2020 and pay no federal or New York gift tax, while the same

gift at death would incur a $1,319,600 New York estate tax. (Note, however, that gifts made within three years of death are brought back into a New York resident's estate for purposes of calculating New York estate taxes.)
- Florida has no separate state gift or estate tax.
- Gifting can result in a trade-off of capital gains tax savings for estate and gift tax savings.

WHO SHOULD CONSIDER GIFTING DURING 2020?

- Clients who are absolutely certain they will never need the gifted assets and can maintain financial independence without those assets and the income they may generate.
- Clients who have confidence the property they gift will appreciate in value before death.
- Clients who believe and are willing to proceed on their belief that federal tax exemptions will be reduced below the current level for a prolonged period of time.
- Clients who are willing to gift the entirety of their exemption now, or at least the majority of it. Because the exemptions may be decreased later, you must give enough now to use what might be taken away. For example, if you have $11,580,000 in exemption now and use $4,000,000 on gifts, and the exemption is later reduced to $5,000,000, you will only have $1,000,000 of exemption left. The $4,000,000 you use in gifts now will be applied against whatever exemption is left after the reduction. In other words, the gift will not be taken "off the top" of the higher exemption amount; it will simply be applied to whatever exemption exists later. That means making large gifts now is the only way to capture the difference between the historically large exemption amount, and whatever the exemption is subsequently reduced to.

MORE REASONS TO CONSIDER ACTING NOW

Various legislative proposals which have been circulating for years could more likely be enacted if the Democrats control Congress and the White House. Some of these proposals would limit certain gifting techniques entirely or significantly curb their effectiveness. These include:

1. Requiring Grantor Retained Annuity Trusts ("GRATs") funded after enactment to have a minimum term of 10 years and a remainder greater than zero, or possibly eliminating GRATs altogether.

2. Eliminating or curtailing the tax benefits of Qualified Personal Residence Trusts ("QPRTs").

3. Imposing a time limit on the protection from GST tax for multi-generational trusts to which GST exemption is allocated after enactment.

4. Severely limiting the use of "grantor trusts" that permit donors to pay the income tax on the taxable income generated by assets gifted into trust without such tax payments being treated as additional taxable gifts.

OPTIMAL GIFTING TECHNIQUES TO CONSIDER

GIFTS TO ESTATE REDUCTION TRUSTS FOR SPOUSE AND/OR OTHER FAMILY MEMBERS

An Estate Reduction Trust is an irrevocable trust created by you for the benefit of your spouse and/or other family members to remove assets and their appreciation from your taxable estate. For married couples, a gift to such a trust can be particularly attractive because your spouse can be the primary beneficiary of the trust, allowing the assets to remain available to your spouse. In addition, if you choose to allocate GST exemption to the gifts to an Estate Reduction Trust, the trust assets and their appreciation can also be removed from the GST tax system for as long as the trust exists, meaning that eventual transfers from the trust to grandchildren and more remote descendants can be made without any transfer tax.

GIFTS TO DYNASTY TRUSTS

A Dynasty Trust is a trust that is designed to benefit multiple generations by continuing to hold property in trust for each generation with the assets in the trust not being subject to estate tax or GST tax. The current increased gift and GST tax exemptions present an excellent opportunity to benefit grandchildren, great-grandchildren and more remote descendants by using those increased exemptions to fund a Dynasty Trust. Estate Reduction Trusts (discussed above) can be designed as Dynasty Trusts. Trusts in Florida can be designed to exist for as long as 360 years and with Connecticut's recent trust law changes, trusts in Connecticut can be designed to exist for as long as 800 years. Because of these extended time periods, Florida and Connecticut residents no longer have to establish Dynasty Trusts in states like Delaware in order to take advantage of longer trust terms. New York, however, still requires that trusts terminate within 90 years, give or take, so New York residents may want to consider establishing trusts in jurisdictions such as Connecticut, Florida or Delaware for this reason.

QUALIFIED PERSONAL RESIDENCE TRUSTS ("QPRTs")

A Qualified Personal Residence Trust is a tax-efficient means of transferring a personal residence to your intended beneficiaries. The concept of a QPRT is relatively simple: the owner of the personal residence transfers it to a trust but retains the right to live rent-free in the residence for a specified number of years. In order to be successful, the original owner must survive the specified number of years. At the end of that period, if the original owner survives, ownership of the residence is transferred to the beneficiaries (or a trust for their benefit) and is removed from the estate of the original owner. At that time, the original owner can rent the property from the beneficiaries (or trust) if he or she wishes to remain in the house. The primary tax advantage of the QPRT comes from the way in which the value of the residence is calculated for gift tax purposes. The value of the gift is not the full value of the residence on the date of the gift, but rather, the gift is valued based on the beneficiaries' right to receive the residence only after the specified number of years. However, no matter how a QPRT is structured to reduce the gift, the gift will still be substantial. With the increased gift exemption, QPRTs may be an appropriate vehicle for people who otherwise would not consider such a gift because they did not have enough gift exemption remaining or did not want to use the more limited exemption.

GIFTS TO LIFETIME MARITAL OR "QTIP" TRUSTS

A Qualified Terminable Interest Property ("QTIP") Trust can be established by you during your lifetime for the benefit of your spouse. No gift tax is imposed on the transfer of assets to a QTIP Trust because the trust qualifies for the marital deduction. While Lifetime QTIP trusts do not use gift tax exemption and therefore are not an effective vehicle for locking in the temporarily increased gift exemption, these trusts allow you to take advantage of your GST exemption in a manner that allows your spouse to continue to have access to the assets during the spouse's life.

FRACTIONAL INTEREST GIFTS

Gifts of fractional interests in assets (including gifts of interests in limited partnerships, limited liability companies or other closely owned corporations) to your beneficiaries may be made at a lower gift tax value than you might initially think. The fair market value of a fractional interest in property is often less than a simple fraction of the fair market value of a 100% interest. This is because gifts of a fractional interest are often not freely marketable and have little or no control over the asset or entity. In such circumstances, the fair market value of a gift may be determined by an appraiser taking into account this lack of marketability and lack of control. Any of the trusts discussed above can be funded with fractional interests in property that take advantage of this valuation method in assessing fair market value. As a result, gifts of fractional interests can often be a way to maximize gift and GST exemptions.

OTHER ITEMS OF INTEREST

Although the coming elections and potential tax law changes that may occur as a result are clearly a planning priority right now, a few changes to retirement account rules and taxation occurred in the last year of note.

CARES ACT

The Coronavirus Aid, Relief and Economic Security (CARES) Act suspended required minimum distributions ("RMDs") for 2020 for retirement plans such as 401(k)s, 403(b)s, 457(b)s, SEP IRAs, Simple IRAs, and traditional and inherited IRAs. An RMD is the amount of money that is required to be withdrawn by the participant when the participant has reached a certain age or by the beneficiary of an inherited IRA. This means participants or beneficiaries do not have to take any distribution from such accounts in 2020 unless they need the funds. This suspension also includes those who may have delayed their first minimum required distribution from 2019 until April 1, 2020.

SECURE ACT

The Setting Every Community Up for Retirement Enhancement ("SECURE") Act was enacted at the end of 2019 and drastically altered rules with respect to 401(k)s and IRAs, particularly with regard to required distributions from these accounts when they are inherited from the original participant.

The Act offers some improvements to the current retirement savings options such as: allowing contributions to an IRA at any age as long as a participant is still working; raising the age at

which a participant is required to start taking required minimum distributions from age 70½ to age 72; incentivizing small businesses to offer 401(k) plans to part-time workers, making it easier for two or more small employers to come together to offer a plan to their employees; and offering a safe harbor to allow employers to provide lifetime income options through annuities within the retirement plans. However, these improvements come at a cost.

In order to pay for the positive changes listed above, the Act imposes a maximum 10 year payout rule for inherited retirement accounts received from a decedent who died in 2020 or later unless the account is inherited by the surviving spouse of the participant. This is a significant change from prior law, which allowed beneficiaries of inherited retirement accounts to stretch required minimum distributions over their expected lifetime. With the enactment of the SECURE Act, the lifetime stretch option will only be available if the beneficiary inheriting the retirement account is the participant's spouse or qualifies for a very limited number of exceptions mentioned below.

All other individual beneficiaries inheriting a retirement account from a decedent who dies in 2020 or later will be required to draw down the entire account within 10 years of the participant's death, thereby accelerating the income taxes due on the distributions and minimizing the amount of appreciation that occurs on a tax-deferred basis. There is no required distribution schedule for the 10 year period, but the entire account must be withdrawn by the 10 year mark. While this may allow for income tax deferral until the 10th year, providing some tax planning options, it still will accelerate the payment of income taxes under most circumstances, and may push beneficiaries into higher income tax brackets as larger distributions are taken over a shorter time frame. There are some exceptions for minor children of the participant (whose 10 year draw down window begins when they reach the age of majority), disabled or chronically ill beneficiaries, and beneficiaries not more than 10 years younger than the deceased owner.

Given the changes to the inherited retirement account rules, it is important that people who have significant retirement accounts review the beneficiary designations and how these coordinate with their overall estate plan to determine if changes should be made given these new rules and limitations.

THE FINAL MONTHS OF 2020

The challenges of 2020 and the resulting uncertainty have caused many clients to review and re-think their estate plans or realize that an update is in order. We remind you of the importance of reviewing your estate planning documents and the titling of assets and beneficiary designations in order to keep them up to date so that they reflect your current intentions and take advantage of the gift, estate and GST benefits available.

We remain optimistic that the medical community and our government will be able to mitigate and solve the current health crisis. In the meantime, Cummings & Lockwood is taking the appropriate precautions to keep our staff and our clients safe and healthy. This may mean that we see you less in person than we would otherwise like and that we are sometimes working remotely. However, you can rest assured that we remain open and you can continue to contact your Cummings & Lockwood attorney by phone or email as you ordinarily would.