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2021 ESTATE TAX UPDATE – THE YEAR OF THE SLAT

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2021 Estate Tax Update – The Year of The SLAT

Introduction and Historical Background

Recent reports of proposed tax increases have resulted in some wealthy clients considering whether tax law changes may create an increased tax burden for their families in the future. As a result, some taxpayers have revisited the estate tax rules, the fact that they are scheduled to change in 2026 and considered whether planning today might mitigate some of the future expenses. This article will address an estate tax saving strategy that has become popular for married couples. Even for couples that choose not to proceed, many have asked whether it is appropriate for them and how it would work.

By way of background, the Federal Estate tax and the Federal Gift tax are combined together to result in a single "transfer" tax system. When an individual makes gifts during life, the gifts consume the amount of the exemption from the testamentary federal estate tax calculated at death. The tax is imposed only on the amount of assets above an "exemption," meaning it only applies to the "wealthy" and the exemption threshold defines how the federal government defines "wealthy" for this purpose. The federal estate and gift tax exemption, called Basic Exclusion Amount ("BEA"), was permanently set at $5,000,000 in 2010, indexed for inflation, and retained from expiring in 2013. The 2017 Tax Cut and Jobs Act ("TCJA") "doubled" the exemption –*but only until January 1, 2026*, resulting in a current 2021 exemption threshold of $11,700,000 (when considering inflation adjustments). Because of the "sunset" reduction in the exemption in 2026, action today could result in long term savings.

Similarly, in 2012, the federal estate tax exemption threshold, then $5,000,000, was potentially going to be reduced to $1,000,000 per individual. Some families chose to take irrevocable steps to "lock in" the exemption before it expired. As it turned out, the American Taxpayer Relief Act of 2012, enacted in 2013, maintained the existing $5,000,000 exemption from estate tax making the steps taken unnecessary. However, in 2020 and continuing into 2021, the potential for future reduced exemptions has some families considering whether they should *use* exemptions so they do not *lose* exemptions.

As you may have read, on September 13, 2021, the Ways and Means Committee of the United States House of Representatives (the principal tax writing committee) proposed substantial tax changes as part of the Build Back Better Act. While changes to the Build Back Better plan have been made since September, the proposal prompted some to consider planning. Several of the provisions in the bill could have had a dramatic impact on estate tax planning and commonly used planning techniques but the estate and gift tax provisions have been eliminated from the bill (as of the writing of this article).

Attention to the possible reduction in the BEA exclusion began in earnest when it was clear that President Biden would be elected. Estate planners began to alert clients on the assumption that changes could be forthcoming. The potential possibility for estate tax change was not a new concept. Throughout President Obama's term, the Obama administration's position remained constant, to fix the estate tax exemption at the sum of $3.5 million per individual. Early in 2021, Senator Sanders made a proposal to lower the exemption to $3.5 million per individual. Even during the Trump administration, several bills had been introduced that would have accelerated the estate tax exemption reductions (increasing the tax).

One provision of the September House Ways and Means proposal would be to allow the "doubled" exemption (brought about by the 2017 TCJA) to expire at the end of *this* year, so that effective January 1, 2022, the BEA would be reduced in half. It appeared, with the inflation adjustment, the BEA effective January 1, 2022 would have been reduced to about $6,020,000.

One popular gifting strategy involved an irrevocable gift where one spouse creates a trust for the benefit of the other spouse. This approach has been referred to as the "Spousal Lifetime Access Trust" (or "SLAT") and thus, this outline will review the use of this plan and the long-term implications, filing obligation and practical issues, that every CPA should know. Hence, this is "the year of the SLAT." As a CPA or advisor, you may not currently represent clients that have created SLATs; however, everyone will invariably come across a client that has created one. These are *irrevocable* trusts. Thus, it is a crucial for all advisors to understand the why they are created and how they operate. Even then, many more clients that have not implemented a SLAT may have consulted on the operation so it is important to understand some basics.

WHY GIFT NOW?

Because the estate and gift tax structures are unified into a single "transfer" tax, there are two mechanisms to lock in the tax consequences- make an *irrevocable* gift or pass away. Obviously, passing away is neither favored, nor an option to plan for. A more palatable and appealing option is for a client to make an irrevocable gift, in which case the current available estate/gift tax BEA exemption can shelter the gift from tax. The normal "downside" to a lifetime gift is the loss of the "step up" in income tax basis that occurs when an individual passes away owning an appreciated asset.

If a gift is considered, the use of a trust is an age-old mechanism to separate control of the gifted property from the benefits of the property. A trust can also be used to defer the timing of receipt of the benefits of the gifted property. Thus, if the donor wanted to have the property go to the heir after the donor has passed, the trustee can hold the funds until passing (or sooner or later) to coordinate with the donor's wishes.

To order to *make* an $11.7 million dollar gift, one *needs* to have $11.7 million. In addition, one also needs to have additional funds to live on. More importantly, one needs to consider that certain assets cannot be gifted, such as a retirement account, a personal primary home and other things that carry tax ramification on transfer. Thus, the process of creating a SLAT is more involved than just the trust creation and operation, it also involves extensive discussion with the clients about how the strategy will fit into their overall lifestyle and long-term plan.

An interesting issue related to gifting and funding a trust was raised in a United States Tax Court decision this year. Often, married clients are confronted with assets being held in a manner that is not conducive to the plan. For example, sometimes one spouse may find that the assets they want to gift are held by the other spouse or that they are held jointly. Advisors should take care to make sure that not only the form of the plan is documented but also that the substance is carried out.

In *Smaldino v. Commissioner*,[1] Louis Smaldino, a successful CPA and very wealthy man, made a gift to his wife in a family Limited Liability Company, Smaldino Investments LLC that held underlying valuable real estate. The transfer to his wife was disregarded for tax purposes.

Louis had created a trust for the benefit of his children from a prior marriage and funded it with an eight (8%) percent interest in the LLC. That gift used up his remaining BEA. He also made a gift to his wife (who was not the mother of the children) of forty-one (41%) percent of the LLC. Mrs Smaldino received the gift and immediately (the same day) transferred the forty-one (41%) percent LLC interest to the trust that her husband had created. The gift to the trust was intended to be sheltered by Mrs Smaldino's BEA. At issue in the case whether the transfer by Louis to his wife should be treated as a gift which would qualify for the federal gift tax marital deduction or whether the gift should be treated as a gift directly by Louis to the trust.

The court concluded that the gift to Mrs Smaldino should be disregarded because of the substance of the transfer, not the form. Many advisors will recommend that when funding trusts, assets be held in the name of the donor for a period of at least thirty (30) days, although there is support for having the assets held by the donor for a shorter term. The facts in *Smaldino* present a particularly bad scenario. Not only did the transfer take place in a matter of a day, but also, the court thought there was a question (because of the way matters were dated) of whether they were signed in August and back dated to April. Moreover, Mrs Smaldino said that she had made a commitment and promise to gift the shares to the trust before they were even transferred to her. Thus, the court found that she was never really an owner and could not have made the gift. (NOTE: the tax return for the LLC did not even give her a K-1 for any share of the earnings during the year.)

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[1] TC Memo 2021-127 (Nov. 10, 2021).

One interesting aspect to this case is that Louis, as a CPA, should have known better. There were many details that should have been correctly documented for the transactions to be respected.

CLAWBACK AND GRANDFATHERING OF GIFTS MADE

If a taxpayer/donor is interested in making a gift to preserve the exemption, a problem arises due to the manner in which the estate tax is calculated. A concept known as "clawback" occurs when an estate tax exemption amount decreases. In 2017, when the estate tax exemption was "doubled" by TCJA,[2] Congress was aware that the tax calculation contained a fatal flaw related to gifting plans. As noted, in 2012, there was a concern about "clawback" but there was no real solution. Thus, in 2017, as part of the TCJA, Congress, being aware of the dilemma, directed the IRS to provide regulations to rectify the calculation problem.

Here is the technical concern. The estate tax is calculated by combining the amount of assets remaining in a decedent's estate at death and the cumulative "adjusted taxable gifts" made over the decedent's lifetime. Adjusted taxable gifts include only gifts in excess of the annual exclusion amount, now $15,000 per donee.[3] Under the existing tax calculation, a higher estate tax exemption is only applicable to a decedent who actually passes away when the exemption is higher and files an estate tax return (IRS Form 706). In other words, gifts made by the decedent during life are added back to the value of remaining assets in the estate at death and then, that sum is reduced by the BEA in the year of death. As such, any benefit to the irrevocable transfer by gift during the year of the higher exemption period would be lost, or "clawed" back.

> Pre 2017 Example
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> John Q Taxpayer has a $15 million estate and makes a $10 million gift in a year in which the estate tax exemption is $10 million. The gift would be sheltered by the exemption. Suppose he passes away any year in which the estate tax exemption has dropped to $5 million. Suppose also that he still has the $5 million remaining in his estate.
>
> The tax calculation would add the value of assets in his estate ($5 million) to the prior gifts ($10 million) resulting in a total "taxable estate" about $15 million. Since the tax calculation would call for reduction of this "taxable estate" by the

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[2] Unless otherwise indicated, all references to "section" or "§" are to the Internal Revenue Code of 1986, as amended by the Tax Cuts and Jobs Act ("TCJA"), and all references to "Treas. Reg. §," "Temp. Treas. Reg. §," and "Prop. Treas. Reg. §," are to the final, temporary, and proposed regulations, respectively, promulgated thereunder (the "Regulations"), as in effect as of 2020. All "Service" or "IRS" references are to the Internal Revenue Service.

[3] I.R.C. Section 2503.

exemption in the year of death, tax would still be due on $10 million ($15 million less the $5 million in the year of death) even though the $10 million gift made was permitted to be made tax free at the time.

As a result of TCJA, on November 22, 2019, the IRS issued Final Regulations under "clawback" of estate tax exemption.[4] The Final Regulations are generally "taxpayer friendly." However, before embarking on any complicated gifting strategies, taxpayers should be warned to consider the impact of the regulations and their effect on any contemplated transfer.

Several important takeaways can be discerned from these Final Regulations as noted below.

- First, when an individual makes a gift, the gift will only be protected by these clawback Regulations to the extent that the cumulative gift amount **exceeds** the BEA in the year of the decedent's death. For purposes of the examples herein, we will refer to the "permanently" set $5,000,000 exemption as the BEA and the excess (doubled) exemption as the "bonus" exemption. Under the regulations, a gifting strategy will only help the taxpayer to the extent that the gifts exceed the BEA.
    - EXAMPLE 1- If an individual gifts $5,000,000 in an era when the bonus exemption is $10,000,000 and passes away after the expiration of the bonus exemption, the amount to be consumed or added back at death would be the $5,000,000 BEA and no portion of the bonus would help reduce the estate tax because the taxpayer's gifts did not exceed the BEA in the year of death.

    - EXAMPLE 2 – If an individual gives away $8,000,000 in an era when the bonus exemption was applicable, and the BEA is $5,000,000 at death, that decedent will have protection from an $8,000,000 gift even after expiration of the bonus exemption. The amount to calculate the estate tax at death will be reduced by the $8,000,000 used exemption and not by the $5,000,000 BEA generally available for decedents that year. In other words, the exemption for calculating estate tax is the higher of the gifts made or the BEA in the year of death.

- A second key element to the Final Regulations, which was not apparent from previously Proposed Regulations,[5] relates to the "Deceased Spouse's

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[4] *See* 84 FR 64995, Treas. Reg. § 20.2010-1(c).

[5] In November 2018, the IRS issued proposed regulations to address this concept, IRS Notice IR-2018-229.

Unused Exemption" ("DSUE"). Since 2011, a surviving spouse can elect to "port" the exemption amount of a predeceased spouse by filing an estate tax return timely with the Internal Revenue Service. This means that the surviving spouse/surviving parent can, at death, utilize the sum of the deceased spouse's unused exemption and the surviving spouse's unused exemption. The final regulations make it clear that when a spouse passes away any DSUE, if claimed by the survivor, must be used by the survivor before other gifts reduce the BEA of the survivor.

- EXAMPLE 3 – If a spouse claims to "port" the unused exemption of a spouse who has passed away during the bonus era, the amount ported, $11,7000,000 for 2021 decedents assuming the entire exemption is unused, will be available to the survivor notwithstanding any future reductions in the estate tax exemption threshold. With respect to the DSUE during the life of the survivor, the regulations make clear that a surviving spouse making gifts must use the DSUE before utilizing any of his/her remaining exemption whether it is the BEA or any bonus exemption available.

The regulations are important not only for what they do say, but also for what they do not say. Based upon the Regulations that had been proposed in 2018, there had been speculation that several techniques could lock in an exemption, reserve the benefit of the assets for the surviving lifetime of a donor, but yet preserve the exemption. These techniques would be made through the implication of I.R.C. Sections 2701 or 2702 which both accelerate the gift tax calculation on gifts made where certain interests are retained by the donor. The provisions of I.R.C. Sections 2701 and 2702 were enacted in 1990 in an effort to prevent an abuse of several planning techniques which had been popular in the 1980s. While the regulations do not deal with this issue, the preamble indicates that the IRS will issue guidance attempting to outlaw planning mechanisms designed to use the provisions of the Code to circumvent the means which they were originally intended.

Finally, there had been a concern about the use of the generation skipping tax ("GST") exemption. The GST exemption available under the Code has been matched to mirror the amount of the estate tax BEA even though it is used on different types of transfers and, therefore, consumed by taxpayers at different rates. Nevertheless, the regulations do not clarify and provide guidance on the GST exemption.

INCOME TAX BASIS– THE "DOWNSIDE" TO GIFTING

One big "tax downside" to a lifetime gift is the loss of the "step up" in income tax basis that occurs when an individual passes away owning an appreciated asset. There are other nontax disadvantages, most notably, loss of use and control of the asset. There will be

filing obligations noted below and paperwork, but the biggest concern is often the loss of the adjustment of basis under I.R.C. Section 1014.

Generally, gain on the sale of an asset is calculated by using the seller's cost "basis," or, for real estate, the depreciated "basis." When a person passes away with an appreciated asset, the basis of the asset is "stepped up" to the fair market value of the asset on the date of the decedent's death.[6] The estate of the decedent or beneficiary of the asset can then calculate the gain on the sale of the asset based on that stepped-up basis, often resulting in the elimination of any gain and thus any income tax. This is therefore a significant exception to the normal "cost" basis rule of I.R.C. Section 1012 and imposition of capital gains tax. This exception is lost, however, if the asset is gifted to the recipient during the donor's life rather than on death. In that case, the recipient will receive a "carryover" income tax basis from the donor and lose the possible income tax benefit of the stepped-up basis.[7] Thus, while a lifetime gift can preserve the current available estate/gift tax exemption, such gift comes at the cost of losing the possible benefit of the step up in basis.

As a result of this significant issue, the assets that should be utilized in a gifting strategy are usually assets that are not expected to be sold for a significant term. For example, sometimes stock in a family business or a family vacation home will be expected to be held for a significant period of time. These assets may be preferred for this technique. The gain on sale will only occur if, and or when, those assets are eventually sold. If it is clear that an asset will be sold at, or shortly after, the passing of the donor, one must consider the fact that there will be income tax, not only for federal purposes, but also for state purposes. If the gain is capital gain, there may still be a benefit if the rate is lower than the forty (40%) percent estate tax bracket. However, the potential for added taxes, such as an enhanced capital gain rate, net investment income tax or even surcharges may make the use of such an appreciated asset less desirable.

IS IT WORTH IT? IS THERE EVEN GOING TO BE AN ESTATE TAX SAVING?

Is estate tax planning even worthwhile? There has been a tremendous swing in applicability of the federal estate tax over the last forty (40) years and even in the last twenty (20) years since the start of the George W. Bush administration. Before 1981, the estate tax applied on estate values over a mere $60,000. The estate tax exemption (then called "unified credit" amount) of $600,000 was enacted as part of the Reagan tax cuts of

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6 *See,* I.R.C. Section 1014.

7 To make matters worse and more confusing, the plan proposed by President Biden through the Treasury Department "Green book" wish list, would, except for limited exceptions, not only repeal the step up in income tax basis at death but it would impose a recognition event on appreciated assets, like the "Canadian" tax at death. Several proposals, one by Senator Sanders (I-VT) and one by Senator Van Hollen (D-Md) would simply eliminate step up in basis.

1981, the Economic Recovery Tax Act ("ERTA") which remained in effect until 1997. Tax rates went has high as sixty (60%) percent. At the time, the ERTA was considered to be a massive tax relief measure, excluding many (maybe most) families from the estate tax base. The exemptions were again increased in 1997 by the Taxpayer Relief Act of 1997 so that the exemption would increase slowly to $1M by 2006. However, the 2001 first "Bush Tax Cut," the Economic Growth and Tax Relief Reconciliation Act ("EGTRRA") called for the exemptions to increase as the top marginal rates decreased and it provided for an intended "repeal" of the tax entirely. Due to budgetary concerns, the tax was to be repealed only for 2010 decedents where it would expire in 2011.

As a complete surprise to planners, individuals who passed away in 2010 had no estate tax imposed; however, just before the end of 2010, when the law was about to return to $1 million per person threshold, a temporary fix occurred. For 2010 decedents, the repeal was coupled with complicated income tax rules called 'modified carryover basis' which was difficult to administer. As a result of a compromise between the Obama administration and a Republican majority in Congress, a two-year extension with a $5 Million exemption was enacted before being reset by the American Taxpayer Relief Act of 2012.

The "permanent" $5 Million exemption (indexed for inflation) followed in a 2013 compromise with a forty (40%) percent flat bracket by the American Taxpayer Relief Act of 2012. The term "permanent" means five (5) years because the TCJA of 2017 "doubled" the exemption to an $11.7 million per person for 2021 decedents and about $12,060,000 for 2022 decedents. However, as noted, the "doubled" exemption sunsets on January 1, 2026.

Such constant changes make planning quite difficult. Unlike income tax planning which addresses a defined tax period, transfer tax (estate, gift and generation skipping) planning covers a generational period. Since we don't know when anyone will pass away, the planning is much more problematic. Thus, "estate tax planning" is much more of an art than a science.

A common theme to be reiterated from this relatively recent past is this, predictions of estate tax planners are nearly always wrong! Just about every professional "thought" there would be no complete repeal in 2010, we were wrong. Many/most believed that gift planning in 2012, when the then $5M exemption was set to revert to $1M, was prudent. Thus, clients should be advised that their planning steps are based on guess work as much as anything. More importantly, unless a client is comfortable with the plan from a non-tax standpoint (such as making large gifts to minimize tax), they should be avoided. Similarly, many planners thought the BEA would drop immediately upon control of Congress and the Presidency by the democratic party. So far, that has not happened.

One of the major elements to American Tax Relief Act of 2012 was the fact that it supposedly gave the estate and gift tax planning community a “permanent” law upon which taxpayers could rely. The 2012 law provided that the estate tax would only apply to estates where the value of the estate was greater than $5,000,000. Better yet, the $5,000,000 threshold was indexed for inflation (starting in 2010) so that the federal estate tax would only apply to estates with a value in 2013 greater than $5,250,000. It was immediately recognized that “permanency,” would last only if Congress does not change it. No one knows what the rules will be in 2023 or 2033 or 2043 when the client may pass away so “permanency” will remain elusive. At this point the estate tax exemptions have been, and are scheduled to be:

Calendar Year	Estate Tax Exemption	Gift Tax Exemption
2010	$5,000,000 or $0	$5,000,000 or $0
2011	$5,000,000	$5,000,000
2012	$5,120,000	$5,120,000
2013	$5,250,000	$5,250,000
2014	$5,340,000	$5,340,000
2015	$5,430,000	$5,430,000
2016	$5,450,000	$5,450,000
2017	$5,490,000	$5,490,000
2018–2025	$11,180,000 (Indexed)	$11,180,000 (Indexed)
2019	$11,400,000 (Indexed)	$11,400,000 (Indexed)
2020	$11,580,000 (Indexed)	$11,580,000 (Indexed)
2021	$11,700,000 (Indexed)	$11,700,000 (Indexed)
2026	About $6.5M (Indexed)	About $6.5M (Indexed)

Taxes being imposed on wealth transfers at death have existed since ancient Egypt in 700 B.C. They were common in feudal Europe and in the United States, an estate tax was included in the Stamp Tax Act of 1797, the Revenue Act of 1862 and the War Revenue Act

of 1898. The modern federal estate tax has a long history (not worth re-iterating here) however, the tax has existed in its current form since 1916.

The tax is imposed as a transfer tax, combining both lifetime gift tax transfers and transfers at death. First, you would compute the value of the "gross estate," claim deductions and add back lifetime transfers (gifts made). The tax payable is imposed after a credit representing the tax on the available exemption amount. This results in an exemption, so the tax does not apply unless the value exceeds a threshold amount. In sum, that exemption amount is subject to political tides.

In its current form the tax is imposed at a flat forty (40%) percent tax on the excess over the available exemption amount, now called the BEA. However, earlier the tax has been imposed with graduated rates, some rates as high as sixty (60%) percent. Even the name of the exemption has fluctuated. Prior to 1997, this exemption was called the "unified credit amount." In 1997, the name was changed to "applicable exemption amount." In 2010, the name was changed to "basic exclusion amount." Nevertheless, the concept remains the same, a tax is imposed on the excess above a certain threshold. Because the tax to be imposed is a changing threshold that will become fixed at an uncertain date in the future (the clients passing), it is difficult to plan.

Making things more confusing is that the estate tax may be radically reformed. In May, 2021, the Treasury Department proposed it's "Greenbook," the Administration wish list for tax reform. It outlined the potential "Canadian" system where death is an income tax realization event. There were some exemption thresholds both for asset classes and for "small" estates. The anticipated "step-up" for which many clients hoped, may not even exist by the time of their passing. There could be a structure where the tax is imposed at death or that carryover basis applies to impose a tax only when the asset is sold. Presumably, there would be exceptions for spouses and for charitable gifts.

RETROACTIVITY

Another concern is that change can be retroactively applied. Usually, the effective date for a legislative tax law change is the date a bill is introduced into the Ways and Means committee of the United States House of Representatives. If that bill eventually makes it all the way through the process to become a law, the effective date is usually triggered to that initial introduction date. Sometimes, in the legislative process, that effective date is postponed; however, the goal of this approach is to prevent individuals from acting upon the introduction of bills by taking corrective action. Because the effective date is usually set, there is the threat that the time for corrective action has already passed. However, many believe that Congress could enact a change to the estate/gift tax retroactively to, say, January 1 of the year introduced.

In 1996, the United States Supreme Court addressed this issue in *Carlton v. United States*.[8] In that case, a law had been passed through the Tax Reform Act of 1986 to permit a fifty (50%) percent exclusion of Employee Stock Ownership Plan ("ESOP") assets from the estate tax base. Under the law as passed, a decedent did not even need to own the ESOP assets at death if held on the date the estate tax was due. Thus, a clever executor purchased ESOP assets and claimed the exclusion when the estate tax return was filed, saving $2.5 million in estate tax. This drafting oversight was corrected by Congress retroactively (and the ESOP exclusion was also repealed) however, in *Carlton*,[9] the Supreme Court unanimously upheld the retroactive change. Perhaps there might be a different policy rule for a retroactive change is someone had actually passed before the change, but that might not be as persuasive if the individual had merely chosen to make a gift.

SUMMARY

Why consider all of this history? Clients need to be aware that planning for a moving target is always problematic. Steps should only be taken if a client is comfortable with the plan. For the more affluent clients that have been seeking guidance from estate tax planning professionals, the question of what to do creates a difficult quandary because, among other things, the changes, even if declared to be "permanent," are *not permanent*. Future laws may change or eliminate the tax. Should the potential for estate taxes be considered or ignored? Not many clients can afford to permanently relinquish the substantial sums that need to be gifted in order to preserve this tax benefit; however, for some married spouses, this alternate approach could be considered.

THE SPOUSAL LIFETIME ACCESS TRUST ("SLAT")

What is a SLAT? A SLAT is an irrevocable trust created by one spouse for the benefit of the other spouse. The gift to the trust is structured as a gift to a trust under which the donor spouse has no legal right to any benefit. During the life of the recipient spouse, the benefits of the trust could be available to the family unit however, the donor spouse has no legal rights to the assets. The recipient spouse can be a trustee, can receive income from the funds and can invade the principal of the trust for "health, maintenance and support in reasonable comfort."

Like all planning techniques, there are drawbacks.

- First, the *donor spouse* is not a beneficiary of the trust. If the recipient spouse passes away, the benefits of the trust pass to the remainder heirs (away from the donor). This can be mitigated in

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[8] 512 U.S. 26 (1996).

[9] *Id.*

some cases if the recipient spouse can obtain (or owns) a life insurance death benefit that can provide for the donor spouse. Similarly, if the spouses divorce, the benefits of the trust will not be available to the donor spouse.

- Second, the trust for the spouse will almost always be a "grantor trust" which, as noted below, can be a good thing. However, there are certain situations where a donor spouse might want to cease paying the income tax bills. With such a SLAT trust, that is not possible without other legal issues.

In many cases, clients are uncomfortable parting completely with significant funds and, as such, many of these trusts were established with either the obligation or right to make distributions to the grantor's spouse. When the income of the trust can be held or accumulated for the benefit of a spouse, under I.R.C. Section 677, the trust is a "grantor trust" under I.R.C. Sections 671-679, *et. seq.* However, where both spouses are living, it is beneficial that distributions of principal can be made to satisfy any overbearing income tax obligation. The distribution is made to the beneficiary spouse, not the original grantor.

A SLAT IS JUST A "CREDIT SHELTER" TRUST CREATED DURING LIFE

Traditional or historical *testamentary* planning for spousal estates involved each spouse leaving assets in a trust for the survivor (or for the survivor and other family members) with the thought that the trust assets would both, (i) be excluded from the estate of the survivor and (ii) be "sheltered" by the estate tax exemption of the predeceasing spouse. The creation of a SLAT is a way of making an irrevocable *lifetime* gift to "lock in" the use of the exemption available before it is reduced.

In other words, for decades with testamentary planning, the goal had always been to transfer to a surviving spouse (outright or in trust) an amount permitted to defer any tax until the death of the surviving spouse/surviving parent. This share could be outright or in a trust (sometimes called "Marital Trust") for the surviving spouse. Since the estate tax exemptions have been rising in the last twenty (20) years, more and more, this share is zero. The balance (i.e., the amount of the exemption) would pass in another trust, sometimes called a "credit shelter" trust.[10] If there was a Marital Trust created, the "credit shelter" trust could have the same terms, similar terms or different terms depending on the family situation.

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[10] This trust has many names, By-Pass Trust, Family Trust, or Residuary Trust, but essentially, it is excluded from the estate tax base of the surviving spouse. The term "credit shelter" is now ancient nomenclature. Before twenty (20) years ago, a "unified credit" was permitted to reduce taxes. Now, modern language uses the term applicable exemption amount or "basic exclusion amount."

This strategy had always been effective not only for federal tax planning, but also for New Jersey estate tax planning. In light of the current high federal estate tax exemption threshold and no New Jersey estate tax,[11] the testamentary plan in many of our client's testamentary documents could place virtually all of their assets in the trust "sheltered" from estate tax. In the event the surviving spouse is not comfortable with the disposition terms, then the plan will not efficiently achieve its intended goal. More importantly, it may preclude the opportunity to receive a "step up" in income tax basis brought about by I.R.C. Section 1014 at the passing of the surviving spouse on the assets held by the trust.

The creation of a Spousal Lifetime Access Trust, or SLAT, is merely a "credit shelter" trust that is funded during life. The gift must be structured as a gift to the trust under which the donor spouse has no legal right to any benefit, but yet, during the life of the recipient spouse, the benefits of the trust could be available to the family unit, including the donor spouse if the recipient spouse chooses to use his or her distributions from the trust for the benefit of the donor spouse. The recipient spouse can be a trustee, can receive income from the funds and can invade the principal of the trust for "health, maintenance and support in reasonable comfort." Moreover, the surviving spouse can have a "power of appointment" among the family, either during life or at death.

Since 2012, the use of "portability" of estate tax exemption can also be a mechanism to avoid the creation of the "credit shelter" trust described above. The 2012 tax act solidified I.R.C Section 2010(c)(4) which allows a surviving spouse to claim or "port" the tax exemption of a deceased spouse to the survivor without the use of the "credit shelter" trust. Remember that reliance on portability requires clients and their advisors to be mindful that when a spouse passes away, there may be important decisions to be considered to implement a plan. A "portability" election under I.R.C. Section 2010(c)(5)(A) must be made on a timely filed return within nine (9) months of death. However, because so many taxpayers failed to keep the advice of the tax planners to timely elect portability between 2012 and 2014, the IRS issued Rev. Proc. 2014-18.[12] In that pronouncement, the IRS granted relief for taxpayers to make late portability elections until December 31, 2014. Even still, after 2014 the barrage of Private Letter Ruling requests to the IRS that asked for special relief because of missed portability elections, a second relief ruling, Rev. Proc. 2017-34,[13] once again granted relief for missed opportunities. Now, an executor has two (2) years from the decedent's death to make the late election. Also, "portability" was not applicable under the previous New Jersey estate tax regime.

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[11] While the New Jersey Estate Tax may be reinstated in the future, it has been repealed for decedents passing after December 31, 2017. The New Jersey Inheritance tax still exists.

[12] 2014-7 I.R.B. 513, 2014 WL 289504.

[13] 2017-26 I.R.B. 1282, 2017 WL 2495419.

SLATs as a "Grantor Trust"

Under the "clawback" rules noted above, a gift can be made to lock in use of the exemption by making an outright irrevocable gift or a trust. If a gift is outright to a spouse, there is no benefit since the property would be taxed at the passing of the spouse. Thus, for spousal planning, use of a trust is required. While another popular plan for gifting is to utilize a "grantor trusts" (*i.e.*, a trust in which the donor or "grantor" is deemed to be the "owner" for income tax purposes pursuant to I.R.C. Sections 671-679 (also known as "Subpart e" of "Subchapter J" of the Code). Subchapter J is the part of the Code dealing with Trusts and Estates and Subpart e covers "Grantors and others treated as Substantial owners."

It is possible to create a trust that is both excluded from the donors "estate" for estate tax purposes (and treated as a "complete" gift) AND also treated as the alter ego of the Grantor for income tax purposes (*i.e.*, a "grantor trust"). Said another way, a person can gift to a trust that achieves estate tax benefit even though the grantor must continue to pay income tax on the earnings. This technique of using "Grantor Trusts" has shifted a statutory structure designed to protect against from an income tax planning device into a savings mechanism to reduce "estate tax." This occurs because the grantor's estate subject to estate tax will be reduced by the income tax obligations after funding the trust. The payment of the income tax is not a "gift" (even though it benefits the heirs), it is the legal obligation of the grantor.

Benefits

Why would an income tax problem create an estate tax benefit? Suppose T creates an Irrevocable Trust funded by $5,000,000. Suppose further that the trust earns five (5%) percent per annum, or $250,000. In the event that the trust was taxed on the earnings, the ultimate benefit to the beneficiaries (in a thirty-three (33%) percent income tax bracket) would be $168,000 after paying an income tax of $82,000. However, because of the advent of the grantor trust rules, the $82,000 income tax obligation is not paid by the trust or by the beneficiaries, but instead by the grantor. Thus, in a world where the grantor has a large estate and is limited by $15,000 per annum in annual exclusion gifts, the benefit of paying the income tax results in an estate tax tool. The estate of the grantor is reduced by the $82,000 income tax payment, hence minimizing the ultimate estate tax bill to be paid.

Use of a grantor trust is further beneficial because of the generation skipping transfer tax rules. Recall that an individual is permitted to make gifts of $15,000 per year per donee where funds are gifted even to grandchildren (and younger) descendant beneficiaries. By contrast, suppose T funded the trust by $5,000,000

in a “generation skipping exempt”[14] format such that the benefits can inure to the taxpayer’s child (or children) and, ultimately, pass to grandchildren. Where T could not make transfers to benefit grandchildren without either making direct skips ($15,000 per year individual gifts) directly to grandchildren (the I.R.C. Section 2642(c) benefit) but the $82,000 income tax payment further energizes the benefit to the trust and its beneficiaries on a more significant basis.

I.R.C. Section 677 – Spousal rights create Grantor trust status

Under the Grantor trust rules of the Code, there is a specific provision, I.R.C. Section 677, that creates a grantor trust where a spouse is involved. These statutory provisions treat a grantor as having retained powers where:

- the grantor or the grantor’s spouse can actually, or constructively, receive income. If the Grantor has the right to income, the estate tax benefit is not achieved. This can be limited, if the right to income is only permitted with the consent of an “adverse party” (defined in I.R.C. Section 672 to be a person with a substantial beneficial interest).
- If the income can be held or accumulated for the grantor’s spouse, again subject to the consent of an “adverse party.”
- If the income can be used to pay for life insurance on the grantor or spouse.

The IRS has ruled that grantor trust status for a “spouse” is measured at the date of creation of the trust. Thus, if a spouse is a permissible discretionary beneficiary at the outset, stopping grantor trust status is difficult in the future even if the parties later divorce. Grantor trust status would be terminated at a spouse’s death which also makes for difficult planning if the goal is to maintain grantor trust status for a longer term.

Rev. Rul. 2004-64

Before 2004, numerous IRS public announcements, culminating with Rev. Rul. 85-13,[15] found that a “grantor trust” is no more than the alter ego of the donor. Thereafter, and since 1985, it has been clear that the donor and the donor’s “grantor trust” are treated as the same taxpayer and the grantor is deemed to own the assets of the “trust.” It should be noted that, for state law property rights purposes, the trust terms define rights and obligations irrespective of the tax

[14] A generation skipping exempt format can be established by creation of a trust for the child or children where T allocates his/her generation skipping exemption (on IRS Form 709) against the transfer to the trust. *See* I.R.C. Section 2631.

[15] 1985-1 CB 184.

treatment. In Rev. Rul. 2004-64,[16] the service made it clear that the grantor is obligated to pay income tax on all earnings of a grantor trust. Thus, some families will establish "grantor trust" so that the grantor can pay the income tax (even though the income remains with the trust beneficiaries) and the income tax paid by the grantor will reduce the estate (for estate tax purposes) of the donor.

GENERALLY

As often occurs in the tax law, one abuse perceived by Congress is rectified in a manner that creates other planning opportunities. As noted above, the "grantor trust" rules were originally established as a means of eliminating income shifting. This had much more utility in a circumstance where the progressive tax rates of some taxpayers created a significant desire to "move" income to a lower rate taxpayer. One primary means of rectifying this concern began with the Tax Reform Act of 1986 by "flattening" rates. If all taxpayers are in the same general rate bracket, the need and utility for shifting income to a lower bracket taxpayer dissipates. However, since the creation of the rules, rates have been becoming lower and more compressed in exchange for denial of income tax deductions. The grantor trust statutes required that trusts, then a low-income tax bracket taxpayer, would be taxed instead at the higher rate of the original, presumably high bracket, taxpayer. As the decades have passed, income shifting needs have dissipated and estate tax planning needs have risen. Thus, the use of a grantor trust is now a tax planning tool designed to minimize the estate of the grantor by payment of an income tax liability where the actual income and earnings inures to the benefit of the beneficiaries.

While it had been long thought that the payment of the income tax liability noted above was not a "gift" for gift tax purposes, this technique received added viability in Rev. Rul. 2004-64.[17] In this ruling, the IRS provided three (3) hypothetical "situations" to enunciate its position.

SITUATION ONE

In Situation One, the IRS reviews the facts noted in the example provided above. A trust is established by T for the benefit of the beneficiaries and it is a grantor trust for income tax purposes. The trust is an Irrevocable Trust intended to be excluded from the grantor's estate and the grantor pays income associated with income earned by the trust. In this Situation, the IRS ratifies the premise that the payment of income tax liability made by T is not a "gift" or gratuitous transfer because it represents the legal obligation of T.

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[16] 2004-2 CB 7.

[17] 2004-2 CB 7.

Situation Two

In Situation Two of the Rev. Rul. 2004-64,[18] the IRS modifies the facts to require that the trustee reimburse the grantor T for payment of an income tax liability. The trust remains a grantor trust for income tax purposes. However, because of the "retained" interest in the income of the trust, the gift to the trust is not "complete" for estate tax purposes. Thus, the trust would be included in the estate of the grantor upon the grantors passing.

Situation Three

In Situation Three, the IRS modifies the same facts above to indicate that the trustee is permitted, either by the terms of the trust or by State law, to reimburse the grantor for income tax costs. However, in Situation Three the trustee is not obligated to reimburse the grantor like in Situation Two. Under the facts presented in Situation Three, the IRS considered a case where the governing instrument of the trust provided the trustee with discretion to reimburse the taxpayer from the trust assets to pay the tax. While the IRS continues to agree that the trust is a grantor trust and the payment of the income tax liability is not a gift by A if paid independently, a concern is raised by the Service. It finds that the payment, as reimbursement by the trust to the taxpayer, was likewise not a gift by trust beneficiaries back to the original grantor. However, unlike the mandatory payment under Situation Two which caused estate tax inclusion in the taxpayer's estate, the Service found that the trustee's discretion to satisfy the tax bill would not, by itself, cause inclusion of the assets in an estate for federal estate tax purposes. Nevertheless, the Service considered the fact that the discretion, combined with other factors such as an understanding or prearrangement between the taxpayer and trustee or the taxpayer's ability to remove or replace trustee, could give rise to a circumstance where the trust could be taxed as part of the taxpayer's estate. If the repayment was understood, the trust would be taxed to the grantor at death as an "implied" retained interest. In this Situation Three holding, the IRS also considered whether applicable local state law could give the trustee discretion to satisfy the payment. In such case, local law alone may cause inclusion of the assets in the trust in A's estate for federal estate tax purposes.

State Law Efforts to Correct

As a result of the ruling in Situation Three of Rev. Rul. 2004-64,[19] the Real Property and Trust Law Section of the New Jersey State Bar sought, and was

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18 *Id.*

19 2004-2 CB 7.

eventually successful, in revising New Jersey law to prevent New Jersey law from allowing mandated estate tax inclusion for trusts which were intended to be excluded from the estate. Under New Jersey law, N.J.S.A. 3B:11-1 provides that the "right of any creator of a trust to receive either the income or the principal of the trust or any part of either thereof, presently or in the future, shall be freely alienable and shall be subject to the claims of his creditors, notwithstanding any provision to the contrary in the terms of the trust." Thus, presumably the IRS, as a creditor, could have access to trust assets in the event that the grantor were unable to satisfy the tax liability. Accordingly, the law was modified by making the aforementioned provision subparagraph (a) in 3B:11-1 and inserting a new statute 3B:11-1 (b) as follows:

> "A trustee's discretionary authority to pay trust income or principal to the creator of such trust in an amount equal to the income taxes on any portion of the trust principal chargeable to the creator shall not be considered a right of the trust creator to receive trust income or principal within the meaning of subsection (a) of this Section. The trust creator shall not be considered to have the right to receive income or principal of the trust solely because the trustee is authorized under the trust instrument or other provision of law to pay or reimburse the creator for any tax on trust income or trust principal that is payable by the creator under the law imposing such tax or to pay any such tax directly to the taxing authorities. No creditor of a trust creator shall be entitled to reach any trust property based upon the discretionary powers described in this subsection."

Accordingly, while there arguably may have been some concerns created due to the holding in Situation Three, that seems to have been rectified for New Jersey trusts.

Change Proposed in September 2021

The September 13, 2021 House Ways and Means proposal for the Build Back Better Act suggested a variety of significant changes to Grantor trust. That proposal, if it had been enacted, would have repealed the estate and gift tax benefits of making gifts into a grantor trust. The new law would not have affected (or "grandfather") pre-existing trusts, but future trusts and contributions to pre-existing trusts would no longer be permitted. The proposal would have created two (2) new provisions in the tax code, I.R.C. Section 1062 and I.R.C. Section 2901. Under Proposed I.R.C. Section 2901, the assets held in a grantor trust would be "taxable" in the estate of the grantor. Under proposed I.R.C. Section 1062, transactions with a grantor trust would be subject to income tax, unlike current law. Thus, an estate tax would be imposed on some or all of the trust at the death of the donor which would have otherwise been exempted under existing law. Also,

on removal of grantor trust status, the donor will be deemed to have made a gift for gift tax purposes.

The change to grantor trust status would have raised a variety of problems. A trust for a spouse is almost always a "grantor trust." As a result, the creation of a Spousal Lifetime Access Trust ("SLAT") would no longer be permitted. The change would have changed the taxation of trusts created as *irrevocable* trusts to hold life insurance for trusts known as a Grantor Retained Annuity Trust ("GRAT") or Qualified Personal Residence Trusts ("QPRT") both allowed by existing I.R.C. Section 2702. Very briefly, both of these techniques allowed a statutorily sanctioned approach to allow growth in excess of a nominal sum to be passed to heirs on a tax-free basis. The new law would have apparently prohibited this type of transaction because they are grantor trusts. Does this indicate that a Grantor trust is a tax "loophole"? Perhaps.

WHAT HAPPENS WHEN THE GRANTOR PASSES?

GENERATION SKIPPING OR DYNASTY TRUST

In addition to the protection of the estate tax BEA, there are other tax benefits that can be factored into a SLAT as a part of the plan. If the family is interested, the gift to a trust can be a mechanism to allocate exemption from generation skipping tax ("GST"), thereby achieving a long-term intergenerational savings from the transfer tax.

Whether a trust is GST "exempt" over the long term depends on the terms of the trust. If the "child" beneficiary share of the trust at the passing of both spouses remains in trust (rather than distribution outright), the trust can be removed from the tax base of the child and thus, pass to, or for the benefit, of the next generation(s) free from the estate tax that would have otherwise occurred due to the property being in the estate of the child beneficiary. "GST" planning is very long in nature because it exists on an intergenerational basis. However, if one assumes that an estate tax will be imposed, there can be significant tax benefits achieved.

A trust can be broadly drafted for the benefit of a child/beneficiary such that they can serve as a trustee, receive income, receive principal under a tax based "ascertainable standard" ("health, education, maintenance and support in reasonable comfort"). The child can be given a fairly broad power to appoint among their heirs, provided that it does not meet the definition of a "general power of appointment" pursuant to I.R.C. Section 2041. A "general power of appointment" under I.R.C. Section 2041 is the power to leave assets to yourself, your creditors, your estate, or the creditors of your estate. Thus, very long-term benefits can be achieved without diminishing the flexibility and use of the assets to the child/beneficiary. Sometimes, since the repeal of the laws that prevent

assets from being in trust forever (until spent) called the "rule against perpetuities,"[20] these trusts can become known as "Dynasty" trusts.

As noted above, the disadvantage this is to this type of planning would be the loss of the "step up" in income tax basis which would exist if the assets were, in fact, included or "taxed" in the estate of the child/beneficiary.

INCOME TAXES AFTER THE GRANTOR PASSES

A trust can *only* be established as a "grantor" trust while a grantor is living. Once the Grantor passes, it becomes a "non-grantor trust" in which income taxation as a separate legal entity will apply. Trusts can either be a "Simple" trust (that requires all income be distributed) or a "Complex" trust (that allows income to be accumulated. Nevertheless, in either case, grantor trusts status ends and assuming the trust continues, the trust is a separate reporting entity that will file an IRS Form 1041.

RECIPROCAL SLATS

For some spouses, there might also be an opportunity for each spouse to create a trust for the other spouse in order to capture not only one large exemption, but two. If so, the trusts need to be different from one another to avoid the application of the "reciprocal trust" doctrine. For example, in *United States v. Grace*,[21] spouses created nearly identical trusts for each other, and the IRS asserted that the trusts should be disregarded for tax purposes, as if each spouse created the trust for his or her own benefit. The United States Supreme Court agreed with the IRS, and any tax benefits from the creation of the trusts, including the removal of the trust assets from the donors' estates, were denied on the premise that a person cannot retain an interest in a trust and receive the desired gift tax benefits. Thus, in this scenario, the trusts need to be sufficiently different from one another in order to receive the tax benefit of utilizing the current gift tax exemption and removing the assets transferred to the trust from the donor's estate.[22]

PLANNING FOR BASIS ISSUES

The use and creation of a grantor trust is prevalent in practice and in some circumstances may require periodic attention. One tax provision that is typically used to create grantor trust stats without also calling for the trust to be taxable to the estate of the grantor at

[20] In New Jersey the old common law restriction on perpetual trusts was eliminated by the Trust Modernization Act of 1999, P.L. 1999, ch. 159.

[21] 395 U.S. 316 (1969).

[22] *See Estate of Levy*, 46 T.C. Memo 910 (1983), a New Jersey case where the trusts were found to be sufficiently different because powers were granted to the wife in the trust created by the husband that were not granted to the husband in the trust created by the wife.

death is I.R.C. Section 675(4)(c). It provides that a grantor can create grantor trust status when the grantor reserves the right to substitute property of equivalent value. While this is a good tax mechanism, it also provides substantive beneficial rights to the grantor. With respect to income tax basis of the assets held, it opens the door to additional tax planning for which advisors need to consider.

For example, suppose that a trust appreciates in value and the "basis" of trust assets in the hands of the trustee is low. Suppose further the grantor is elderly and has sufficient resources. It may be beneficial for the family for the grantor to substitute "high basis" appreciated assets into the trust in exchange for the low basis assets held by the trust. After the exchange, there is the potential that the low basis assets could receive the "step up" allowed by I.R.C. Section 1014 upon the passing of the grantor. Had the low basis assets remained in the trust, no step up would be received. This is a factor that many clients and advisors may lose sight of, particularly with an aging parent or other relative. Thus, it may be incumbent upon planners to revisit this issue on occasion to insure that the overall family objectives are met, particularly where tax planning is involved. In order to effectuate such a change, the parties must be comfortable that the exchange occurs at fair value. It is not uncommon for grantor trusts to hold low basis assets, particularly when those low basis assets are family business stock.

TAX REPORTING OF GRANTOR TRUSTS

The reporting requirements for trusts are contained in Treas. Reg. § 1.671-4 and reiterated in the instructions to IRS Form 1041. Generally, a trust with income of $600 is to obtain a tax identification number and file an annual income tax return within three and a half months after the end of the taxable year. If only a portion of the trust is a grantor type trust, both methods for reporting (grantor/non-grantor) can be reported and checked on Section A Page 1 on the Form 1041. While a "wholly owned" grantor trust may report its income on the same tax year as the grantor, that usually means that the grantor trust will be obligated to file a calendar year return as required for individuals. In the event that a grantor (such as a corporation) uses a fiscal year, then the grantor trust may file on that fiscal year if it keeps its books and records on that basis. Sometimes this rule will apply to a grantor trust reported for the year of the grantor's passing.

FILING REQUIREMENTS

Grantor trusts are not taxable entities. If the grantor is ***not*** a trustee, the trustee should file trust return attaching a summary of the income and deductions, indicating that it is a grantor trust and it need not complete page one of the IRS Form 1041 Fiduciary Income Tax Reform (other than the headings). If the grantor *is* a trustee, no reporting is necessary; the trust should use the grantor's social security number on all assets. The income and expenses should be reflected on the grantor's IRS Form 1040 Individual

Income Tax Return. For a SLAT, the grantor should ***not*** be a trustee as that would negate the estate tax benefits.

For all grantor trusts, all items of income deduction and credit must be reported on the grantor's personal income tax return. Examples of other grantor trusts include Revocable Living Trusts, trusts that may make distributions to the grantor, the grantor's spouse, or to the grantor's dependents in payment of the grantor's support obligations. Life insurance trusts are usually grantor trusts but typically have little or no income.

Reporting for Irrevocable Trusts

When filing a tax return for an irrevocable grantor trust where the grantor is not a trustee, there are three options for reporting income, deduction and credit.

Option One, the Separate Statement Method

Where a trust is entirely a grantor trust, the trust income tax return (Form 1041) is completed without any dollar amounts being included on the form itself. The first page would only include the basic information such as name of the trustee, the trust, the identification number and address. Under this reporting rule, the amounts of income, deductions and credit reported are to be included on an attachment to the return. The fiduciary must give the grantor a copy of this attachment to allow the grantor to properly file his or her return. On the attachment, the fiduciary should note:

- Name, identifying number and address of the person to whom the income is taxable;
- The income of the trust that is taxable to the grantor in the same amount of detail as it would be reported on the grantor's return had it been received directly by the grantor; and
- Any deductions or credit that apply to this income.

Once again, the trust does not report these transactions directly on the Form 1041, but it merely shows all transactions including sales and exchanges on the attachment. Under the grantor trust principles, the grantor is the "deemed owner" of all trust assets held by the trustee. Thus, while the trust has separate and independent legal status and a beneficial property right interest, for tax purposes (based upon the legal fiction), the grantor is deemed owner of the assets.

Option Two – The W-9 Method

The regulations provide that the method above is the preferred reporting approach pursuant to Treas. Reg. § 1.671-4(a). However, Treas. Reg. § 1.671-

4(b) provides for two additional alternate approaches. The second approach requires that the trustee furnish the name and taxpayer identification number of the grantor (or other person treated as the owner of the trust) and the address of the trust to all payers during the taxable year. Under this method, unless a grantor is a trustee or co-trustee of the trust, the trustee must furnish the correct grantor/taxpayer with a statement indicating the income, deduction and credit to the trust for the taxable year, the payer of each item and the information necessary to take trust activity into account in preparation of the grantor's personal tax return. This statement must inform the grantor of all income, deductions and credits applicable and under this method, the grantor must provide the trustee with a complete Form W-9 (or acceptable substitute Form W-9) signed under penalties of perjury so that the income is being properly reported to the correct source.[23]

Option Three – The 1099 Method

The third applicable means of reporting involves the obligation of the trustee to furnish the name, TIN and address of the trust and comply with the additional requirements noted below. Under this alternative, the trustee must file with the IRS Form 1099s to the grantor showing the trust as payer and the grantor as the owner recipient of income for trust purposes. The trustee would have the same obligations and filing requirements for filing Form 1099s as would a payor making reportable payments except that the trustee must report each of type of income in the aggregate and each type of gross proceeds separately.

Once again, unless the grantor or other person is the trustee or co-trustee, the trustee must also furnish a statement noted above that includes items of income, deduction and credit for the taxable year and provides the grantor with the information necessary to complete the grantor's tax return. It must also inform the grantor of all items of income, deduction and credit to be included in computing the taxable income of the grantor. In other words, under this reporting requirement, the trust is treated as both recipient of income and payer of income to the respective grantor. In practice, the author has seldom seen this approach utilized.

New Jersey Consequences

New Jersey recognizes grantor trusts. In New Jersey, grantor trusts are required to file a New Jersey Gross Income Tax Fiduciary Return, Form NJ-1041. The Division of Taxation provides that if the grantor trust income is reportable by or taxable to the grantor for federal income tax purposes, it is also taxable to the grantor for New Jersey income tax

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23 *See* Treas. Reg. § 1.671-4(b)(ii).

purposes. Specifically, on Line 45 to the New Jersey Form NJ-1041 (2018), the State provides:

> "Enter the name and address, State of Residence and social security number of the taxable grantor. In column A enters the trust's gross income from 14. For a New Jersey non-resident grantor, enter in column B the New Jersey source income from the trust's gross income. If the grantor is a New Jersey resident, the total on Line 46(c) should be listed on Line 34(a) and one Line 34(c) and can be only refunded to the non-resident trust."

As a consequence, planning with grantor trusts in New Jersey is relatively easy.

PENNSYLVANIA CONSEQUENCES

While New Jersey planning with grantor trusts can be seamless, the same does not hold true for Pennsylvania residents. The Pennsylvania rule can apply even where a New Jersey (or other state) holds Pennsylvania source income and is obligated to file a non-resident return. Pennsylvania law varies from federal law regarding grantor trusts as the Commonwealth of Pennsylvania does not apply the grantor trust rules for fiduciary income tax purposes. Pennsylvania law treats the trust as an ordinary trust that is subject to tax. Under Pennsylvania law, distributions to beneficiaries can be passed to the beneficiary, however, the grantor trust would be taxable on the remainder. This occurs for any Irrevocable Trust and will apply when Pennsylvania residents create Irrevocable Trusts that are complete gifts or even for grantor retained annuity trusts or grantor retained unitrusts interests.

EXCEPTION

There is an exception in Pennsylvania for a Revocable Trust or "Settlor Revocable Trust" which, like federal law, are ignored for income tax purposes.

CONCLUSION

'Estate planning' is the process of arranging your affairs to minimize costs and expenses. One cost, that can sometimes be significant, is the estate tax cost. Unfortunately, there are steps in the process where the client needs to speculate on the potential changes that may occur over time. Income tax planning addresses a defined tax period, usually ending on December 31st or a fiscal year end. However, the transfer tax (estate, gift and generation skipping) planning covers an inter-generational transfer. Since we do not know when anyone will pass away, what will be left after the lifetime of expenses and the earnings on the estate, the planning is much more difficult. Thus, "estate tax planning" is much more of an art than a science.

Making irrevocable plans like a SLAT to minimize tax, particularly taxes that will be due after your demise, is always a difficult decision. However, some families may consider the existing rules to be more advantageous than they might be in the future and, with that in mind, may choose to embark on opportunities that exist today.

Invariably, in the course of estate tax planning, clients will choose strategies that may, or most importantly, may not, achieve an intended goal. The goal of the advisor is to provide the client of an understanding of the benefits and pitfalls of the strategy. Many clients embarked on aggressive gifting strategies in 2012 when the possibility existed that the estate and gift tax exemption could change from $5,000,000 to $1,000,000. It turned out that Congress ended up retaining the $5,000,000 exemption so the strategy may not have been needed. If a client went into the plan without a clear understanding of the pitfalls, they may have been disgruntled by the advice. Thus, the key to any successful plan is to try, if possible, to build in flexibility so that the plans adopted today can be modified, as needed, to adapt to a changing world.

NEW RULES FOR NOTARIZATION AND NOTARY PUBLICS

On July 22, 2021, Governor Phil Murphy signed P.L. 2021, ch. 179, A-4250 (Downey)/S-2508(Gopal) upgrading the laws concerning notaries and notarial acts. This new law is the first significant *permanent* revision to notary laws in a long time; however, important temporary measures were put in place for notaries as a result of the coronavirus Covid 19 pandemic in P.L. 2020, Ch. 26, April 14, 2020.

What is "notarization"? When an individual executes a legal document, a licensed notary public serves as an impartial witness to the execution of the document and to the acknowledgement of the signatures on the documents. A notary public can also administer oaths and affirmations. In New Jersey, attorneys can notarize documents and the law applies equally to attorneys[24] and notaries. Before these new laws, the notary and the declarant needed to be in the same room to witness the execution of the legal document.

Pandemic emergency action

As a result of the pandemic, many legal documents, including Wills, could not be executed due to quarantine rules that limited individuals from visiting with their lawyers and staff. As a result, particularly due to the dire effects of a COVID case, many states took prompt action to modify their laws on notarization. On April 14, 2020, Governor Phil Murphy signed a temporary measure into law P.L. 2020, Chapter 26 to allow for "remote" notarization of legal documents as discussed below. The State of New York had taken similar action by executive order of Governor Andrew Cuomo on March 7, 2020 and

[24] See N.J.S.A. 46:14-6.1

Pennsylvania's initial regulatory provision was subsequently overruled on April 20, 2020 when Governor Tom Wolf executed SB 841 to enact a law for Pennsylvania similar to the New Jersey statute. "Remote" notarization is not to be confused with the Uniform Electronic Transactions Act, N.J.S.A. 12A:12-1 *et. seq.* which permits electronic creation of certain documents, but not Wills, Codicils, Trusts, courts records and a host of other legal documents.

THE NEW LAW

The biggest aspect of the new law is that it allows remote notarization. What is remote notarization? It is where a notary uses "communication technology" to witness as the signing party executes a document that is subsequently notarized by the notary. There are two (2) new processes under the law, one can be referred to as "Remote Ink Notarization" (RIN) and the second "Remote On-line Notarization" (RON). With RIN, the notary affixes a stamp to a "tangible record" (e.g., paper) and for RON there is an electronic record. With the new law, both RIN and RON will be permitted permanently, effective October 20, 2021. The permanent law carried forward most of the temporary RIN rules on a permanent basis.

While the enactment of RIN and RON are the major development, there are also other provisions applicable more broadly in the new law.

EDUCATION REQUIREMENTS

While earlier drafts of the bill would have imposed continuing education requirements on notary publics (such as a six-hour course of study and other added continuing education requirements), the bill as finally enacted (the third reprint) deleted those requirements opting instead for the New Jersey State Treasurer to create a course and examination. These new education requirements will take effect in one year (approximately July 22, 2022). Moreover, while there has always been a manual for notaries on the state website, the new law will require the State Treasurer to update it to comply with these added rules. The newly enacted education rules related to notary publics are not applicable to attorneys. In the future, a test will be required to obtain a notary license.

NEW JOURNAL REQUIREMENT

Under the new statute, all notary's are required to maintain a journal of notarial acts performed together with the time and date, type of notarial act, name and address of each individual for whom the notarial act is performed and information concerning the evidence of the identity of the individual as well as any fees charged. There is a limited exception for documents maintained in law firms or title companies.

FEES

The new law modifies the fees that can be charged by a notary and takes steps to revise the stamp and certificate form (jurat) administered.

ELECTRONIC SIGNATURES & DOCUMENTS

Electronic signatures have been permitted in New Jersey for twenty (20) years under the "Uniform Electronic Transactions Act" N.J.S.A. 12A:12-1, *et. seq.* with respect to certain documents. However, a remote notarization is different from an electronic signature, and thus the Uniform Electronic Transaction Act did nothing to allow remote notarizations. Thus, changes were necessary in order to allow notaries to remotely notarize documents.

Moreover, the Uniform Electronic Transactions Act explicitly excluded a variety of transactions,[25] most notably, wills, codicils and testamentary trusts.[26] Those types of documents are not allowed to be electronically signed under the Uniform Electronic Transactions Act.

While there have always been concerns about the ability of a Last Will and Testament to be executed on an electronic record, there has been a movement towards the creation of electronic Wills to allow an e-signature on a Last Will and Testament. In 2019, the Uniform Law Commission proposed creation of the "Uniform Electronic Wills Act". To date, the Electronic Wills Act has been adopted in Colorado, North Dakota, Washington State and Utah. Effective in July 2020, Florida adopted an Electronic Wills Act.

REMOTE INK NOTARIZATION ("RIN") EXECUTION

Under a RIN execution, a "remotely located individual" and notary public can use communication technologies such as "Zoom," "Facetime," "Microsoft Teams," "GotoMeeting," or other video conference capabilities to witness the execution of legal documents to be returned to the notary for subsequent notarization. When a notary utilizes this technique, there are several important requirements:

- The notary must use "identity proofing" techniques outlined in the statute to ensure that the document being notarized is by the individual appearing before the notary.
- The video conference must be recorded and the notary has an obligation to save the video for a period of ten (10) years.

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[25] In addition to Wills and Codicils, the UETA also excluded, inter alia, some transactions under the Uniform Commercial Code, matters related to adoption, divorce or family law and court orders or other official documents.

[26] N.J.S.A 12A:12-3 (b)(1).

- Third, the certificate for the notarial seal must indicate that it was notarized pursuant to this law using communication technology. A notary should make certain that the individual is executing a document which they know and understand to be the document the notary is to notarize.

- The individual executing the document should return the document to the notary for the placement of the notarial seal at a subsequent date. In the opinion of the author, the notary should utilize the date of the video conference on the notarization even though it would actually be signed several days later upon return to the notary.

REMOTE ONLINE NOTARIZATION ("RON") EXECUTION

With an execution of a permitted document by Remote "Online" Notarization (*e.g.*, in an electronic record or format), the notary is to use a service that can secure the transaction and process. The service company will also be responsible for the "identity proofing" process.

ESTATE PLANNING ASPECTS TO RIN AND RON

From an estate planning standpoint, when is this new law most useful? When clients execute an estate plan, it typically involves four (4) legal documents, a Last Will and Testament, an Advance Directive for Health Care, a General Durable Power of Attorney, and in some circumstances, a Revocable or "Living" Trust. Of these four documents, only the execution of a Power of Attorney *requires* the signature of a notary under N.J.S.A. 46:2B-8.9. While it is customary the other three (3) principal estate planning documents to be notarized, as noted below, each can be executed *legally* without notarization.

For an Advance Directive for Health Care ("Living Will") to be executed, N.J.S.A. 26:2H-56 provides that a valid Advance Directive can be executed by having either two (2) witness *or* a notary. Thus, the execution of the document followed by two (2) witnesses would suffice in these trying times. One requirement is that the designated health care representative cannot be one of the witnesses.

A valid Last Will and Testament can be executed in one of four means. Only one of the four means *requires* the notary be present. That is, a Will that is "self-proved" must be notarized pursuant to either N.J.S.A. 3B:3-4 but in New Jersey, N.J.S.A. 3B:3-5 allows the self-proving affidavit to be signed after the will is executed. To be a "self-proved" Will means that the notary attests that the testator and witnesses executed the document as a Will. If "self-proved" the witnesses need to take no further action after the testator passes away. If it is not self-proved, one witness must file a form with the local county surrogate's office after the testator is gone that they saw the Will executed.

The other three forms of valid Will execution are: (i) a Will executed in accordance with N.J.S.A. 3B:3-2(a); (ii) a "holographic" Will executed pursuant to N.J.S.A. 3B:3-2(b); or (iii) a "Writing Intended as a Will" pursuant to N.J.S.A. 3B:3-3. None of these need be notarized. Note that, while the new law allows for remote notarization of a Will, it does NOT allow for remote "witnessing" of a Will. Therefore, like the former temporary law, the *witnesses cannot be remote*, only the notary. Thus, with respect to Wills, the two (2) witnesses necessary to comply with the Will execution requirements outlined in N.J.S.A. 3B:3-2 must be physically present with the testator. In addition, as with the former law, Wills can only be remotely notarized by RIN, and not by RON.

The most common form for execution of a Will would be a Will established under our Wills Statute, N.J.S.A. 3B:3-2(a). With respect to this type of Will, it merely needs to be signed and witnessed by two (2) individuals. Just about anyone that is competent can serve as a witness under N.J.S.A. 3B:3-7. Even an interested beneficiary can serve as a witness.[27] This statute provides that a Will is not *invalid* if witnessed by an interested party, but of course, the Will would need to be proper in every other respect. Thus, a Will can be executed at home using family members as witnesses and even using social distancing techniques. The Will is still valid without the need of a notary.

The other two forms of Will include a "holographic" (or handwritten) Will, where the signature and material portions are in the handwriting of the testator or a "writing intended as a Will." With a Holographic Will, a testator must be careful that they are expressing testamentary intent, that they properly dispose of their wealth, that they name an executor or other fiduciary and, in most cases, remember to waive the normal bonding requirement. If in the handwriting of the testator and executed and usually dated, this is a valid Will. It will obviously help if a holographic Will is witnessed and/or notarized, but that is not necessary. As to a "writing intended as a Will," a testator merely needs to provide his or her "assent" to the document. A "writing intended as a Will" needs to be proved by "clear and convincing evidence" in court and, thus, while appropriate in some extreme circumstances, is not the most optimal method for execution.

Thus, while Wills may still not be electronically signed in New Jersey, they can now be notarized remotely with the use of RIN. However, with the continued push throughout the country to allow for electronic wills, and New Jersey's recent laws indicating a relaxation in the formality of wills (*e.g.*, the remote notarization laws and the "Writing Intended as a Will" provision), we may see a change in New Jersey sooner rather than later.

A Revocable or "Living" Trust merely needs to be in writing. Under our statute for creation of a revocable living trust, N.J.S.A. 3B:31-18, there is no execution requirement. It is always better to have a revocable trust signed by two (2) witnesses and notarized because the testator may relocate to another jurisdiction where such added formalities

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[27] N.J.S.A. 3B:3-8.

are needed. However, it has been suggested that for some clients currently in isolation, a revocable living trust could be signed and a Holographic Will could be created to "pour-over" any assets into the trust. The Holographic Will, as noted, must make reference to testamentary intent and the appropriate other requisites.

KULZER & DIPADOVA, PA

Kulzer & DiPadova, P.A. is a Haddonfield, New Jersey law firm. The firm limits its practice to the areas of taxation and business matters, including business formations, sales and acquisitions, employee compensation, benefit planning and compliance, all phases of federal and state tax planning, compliance, audits, appeals, civil and criminal tax litigation, complex estate planning, estate and trust administration and estate and fiduciary litigation.

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Maureen Jasper, a Principal at WilkinGuttenplan, has been with the firm since 2003. She is a tax professional with the specialization in providing tax consulting and compliance services to her clients.

Her clients include high net-worth individuals, various types of trusts, estates, multi-state corporations and partnerships, and closely-held businesses Maureen's knowledge extends beyond the compliance aspect and encompasses tax planning, tax research and estate and succession planning.

Maureen is actively involved in various administrative functions of the firm including training members of the tax department, coordinating scheduling among the tax department, and coaching young members of the team to become the future leaders of the firm through the firm's Professional Growth Academy. She is also involved in the administration of tax related software within the firm.

PRACTICE AREAS

- Estate and Trusts
- Closely-Held Businesses
- High-Net Worth Individuals
- Real Estate
- Professional Services

LICENSES & CERTIFICATIONS

- CPA License New Jersey

PROFESSIONAL AFFILIATIONS & CIVIC ACHIEVEMENTS

Member of the New Jersey Society of Certified Public Accountants (NJCPA)
Member of the American Institute of Certified Public Accountants (AICPA)
Member of the Greater Middlesex/Somerset County Estate Planning Council

EDUCATION

Maureen graduated with a Bachelor of Arts and a Master of Business Administration from Rutgers University. She continues her education through regular CPE and educational seminars.

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Admitted to practice:

- New York, 1978
- Georgia, 1978
- U.S. District Court, Southern and Eastern Districts of New York, 1978
- New Jersey and U.S. District Court, District of New Jersey, 1979
- U.S. Tax Court, 1980
- U.S. Court of Appeals, Third Circuit, 1981
- U.S. Court of Appeals, Second Circuit, 1982
- U.S. Supreme Court, 1983

Awards and honors

- AV® Preeminent™ Peer Review Rated by Martindale-Hubbell®
- Included in the Bar Register of Preeminent Lawyers
- Included in the list of “Super Lawyers” by New Jersey Magazine
- Included in the list of “Best Lawyers” by New York Magazine
- Recipient of the coveted Alfred C. Clapp Award of the New Jersey Institute for Continuing Legal Education for his outstanding contributions and his ongoing commitment to the advancement of continuing legal education.

Education

- New York University, LL.M., 1982
- St. John’s University, J.D., with honors, 1977
- Case Western Reserve University, B.B.A., Accounting, cum laude, 1970

Areas of Practice

- Taxation
- Estate planning
- Estate administration
- Corporate law
- Contracts

Professional Memberships

- New Jersey State Bar Association _
- Tax Section
- Middlesex County Bar Association
    - Committee on Taxation, 1989–present
    - Vice Chairman, 1996–present
- Essex County Bar Association
    - Chair, Tax Committee, 1988, 1990, 1993
    - Estate Planning Committee, 1997–present
- Central Jersey Tax and Estate Planning Council, 1996–present
- Tri-County Estate Planning Council
    - President, 2000
    - Vice President, 1998
    - Member, 1987–present
- New York State Bar Association

Certifications

- Certified Public Accountant, State of New York, 1972

Biography

- Born in New York, New York