LEGAL UPDATES

2020 Tax Update

This letter discusses major planning issues related to recent estate and gift tax developments. Specifically, this letter highlights key aspects of the recently enacted Setting Every Community Up for Retirement Enhancement Act (the "SECURE Act"), which makes significant changes to retirement plans.

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Dear Clients and Colleagues:

This letter discusses major planning issues related to recent estate and gift tax developments. Specifically, this letter highlights key aspects of the recently enacted Setting Every Community Up for Retirement Enhancement Act (the "SECURE Act"), which makes significant changes to retirement plans. It also addresses aspects of the Tax Cuts and Jobs Act of 2017 (the "2017 Act") that have percolated over the last two years and that impact most of our clients. Note that there have been many changes, and only through individual consultation can we adequately assess how the changes will impact a client's specific situation.

SECURE Act

The SECURE Act, the most comprehensive retirement reform enacted in more than a decade, was signed into law on December 20, 2019. The key changes that will impact individual retirement account owners and participants in qualified plans (collectively a "Participant") and their at-death beneficiaries are as follows:

- *Effective Date*: The SECURE Act applies to qualified plans for Participants who die after December 31, 2019. It will not impact qualified plans for Participants who died on or before December 31, 2019.

- *Additional Time to Contribute to IRAs:* Participants may now contribute to traditional IRAs after age 70 ½, so long as they are still employed and have earned income to contribute to the IRAs.

- *Qualified Charitable Distributions:* Participants may still continue to make qualified charitable distributions from qualified plans. However, if a participant makes a contribution to an IRA after age 70 ½ and then later makes a qualified charitable distribution from the same IRA, the Participant must first recognize ordinary income dollar-for-dollar on any contributions made to the IRA after age 70 ½ before the realizing the benefits of the qualified charitable distribution.

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- *Delayed RMDs:* For any individual born after June 30, 1949, the required beginning date for such Participant to begin withdrawing required minimum distributions ("RMDs") from their retirement accounts is now the later of (i) April 1st of the calendar year following the year the Participant turns 72 years old (instead of 70 ½ under the prior law), or (ii) (for non-IRA based employer sponsored retirement plans such as 401k plans) the calendar year in which the Participant retires.

- *Changes to Stretch IRAs:* Most beneficiaries of a deceased Participant's IRA will now be required to withdraw all IRA assets within 10 years of the Participant's death. This does away with the "Stretch IRA" provisions under prior law, which allowed beneficiaries to "stretch out" RMDs from an inherited IRA over the beneficiary's own life expectancy. The new law effectively accelerates inherited IRA payouts, potentially resulting in higher income taxes on inherited money and increased earned income for the beneficiary. Eligible designated beneficiaries (spouses, minor children, disabled beneficiaries, chronically ill individuals and beneficiaries less than 10 years younger than the Participant) are exempt from this change and are still able to take advantage of Stretch IRAs.

In addition to the SECURE Act's impact on Participants and beneficiaries, the new law includes provisions that (i) encourage small business owners to set up and provide retirement plans for their employees, (ii) allow the use of 529 plans for qualified student loan repayments (up to $10,000 annually), and (iii) permit penalty-free withdrawals of up to $5,000 from 401(k) accounts for adoption or childbirth.

These changes will affect each Participant differently. Those individuals who have specifically addressed Stretch IRA planning in their estate plans will be affected the most. There may be no impact or changes on other individual estate plans due to the diminished tax deferrals on inherited retirement plans caused by these new laws.

Individuals with significant value in traditional IRAs may want to consider advanced planning techniques including ROTH conversions, charitable remainder trusts and life insurance.

Estate, Gift and Generation-Skipping Transfer Taxation

The 2017 Act doubled the estate tax, lifetime gift tax and generation-skipping transfer ("GST") tax exemptions beginning in tax year 2018. Exemption amounts will continue to increase with yearly inflation adjustments through tax year 2025, at which time the exemption amounts will revert to pre-2018 amounts. The 2017 Act maintained the 40% estate tax, gift tax and GST tax for amounts above the exemption. The 2017 Act also preserved the stepped-up basis treatment of assets at date of death.

The new transfer tax exemptions for 2020 are as follows:

- $11,580,000 federal estate tax and lifetime gift tax exemption (increased from $11,400,000 in 2019)

- $11,580,000 GST tax exemption (increased from $11,400,000 in 2019)

- $15,000 annual gift tax exclusion (no change from 2019)

- $157,000 annual exclusion for gifts to a noncitizen spouse (increased from $155,000 in 2019)

These increased exemptions create opportunities to make larger lifetime gifts, to leverage more assets through a variety of estate planning techniques, and to shift income producing assets to individuals such as children or grandchildren, who may be in lower income tax brackets and/or reside in states with low or no state income tax. The increased GST exemption amount also offers an opportunity to allocate GST exemption to prior transfers for which there was insufficient GST exemption available at the time of the original transfer. Such allocation of GST exemption to prior year gifts will be based on current asset values at the time of the subsequent allocation.

With the significantly higher exemptions, clients should review their current trust instruments to ensure they are still in line with their current objectives. This is particularly important for plans that are designed to allocate or distribute amounts based on the available estate tax exemption or GST exemption.

As a reminder, unlimited tax-free gifts can be made for certain medical and educational expenses, but only if the payment is made directly to the medical provider or educational institution.

Absent further legislation, in 2026 the exemption amounts will revert back to prior levels under the American Taxpayer Relief Act of 2012 ($5,000,000 per taxpayer, indexed for inflation for years 2010 through 2025). As a result, the planning opportunities offered by the increased exemption amounts may only be temporary in nature. However, an effective planning strategy is to use current lifetime gifts to utilize the increased exemptions prior to expiration of the 2017 Act. The IRS recently confirmed there will be no “clawback” for lifetime gifts in excess of the estate tax exemption amount when a person dies. Since lifetime gifts use the exemption from the “bottom-up,” this technique is most effective for individuals gifting close to their entire available exemption.

Portability planning continues to take on greater importance given the temporary nature of the increased exemption amounts under the 2017 Act. With portability, a deceased spouse’s unused estate and gift tax exemption can be transferred to and be used by the surviving spouse during his or her lifetime or at death. This allows many clients with A-B trust provisions to amend their current estate planning documents to simplify administration after the first death. The portability election can only be made on the deceased spouse’s U.S. estate tax return (IRS Form 706). The IRS issued Revenue Procedure 2017-34, which allows a surviving spouse to file a federal estate tax return solely to elect portability within two years of the spouse’s date of death, provided that the surviving spouse meets certain requirements. Failure to claim a deceased spouse’s unused exemption results in lost estate tax benefits and may lead to estate tax (or greater estate tax) at the death of the surviving spouse.

Proposed California Estate Tax

For the time being, there will be no state level estate tax imposed on California residents (although other states may impose estate/inheritance taxes on assets with a situs in those states). California Estate Tax Bill 378, which would have imposed California estate, gift and generation-skipping transfer taxes beginning January 1, 2021, failed to pass a floor vote in May 2019. The failed bill was modeled after the federal estate tax and would have imposed a 40% state estate tax on estates worth $3.5 million or more ($7 million for married couples). It would have been phased out at the current federal estate tax exemption of $11.58 million ($23.16 million for married couples).

Although the proposed California estate tax has been withdrawn from consideration for now, it may be introduced at a later point in time. However, it is important to note the uphill process required to implement any proposed California estate tax. Even if a bill passes the floor vote, it would still need to be approved by the Governor and two-thirds of California voters before taking effect.

Estate of Powell and Possible Ramifications for Business Entities

The recent Tax Court case, *Estate of Powell v. Commissioner*, 148 T. C. No. 18 (2017), has created new law that may cause the interests transferred from an individual taxpayer to one or more family members through a business entity to be included in the transferor’s estate for estate tax purposes. The court in *Powell* ruled that the taxpayer’s ability to participate in the dissolution of a family limited partnership, with the cooperation of the other family members, was considered to carry with it the ability to direct the disposition of the partnership’s assets. This ability, coupled with a few other facts, directly resulted in an unfavorable inclusion of the gifted family limited partnership assets in the estate of the taxpayer who had gifted them. This result also occurs where the donor retains the right to participate in decisions related to making cash distributions from the entity to its members. To protect and preserve the careful succession planning that clients have done during their lifetimes, we recommend review by one of our attorneys of all partnerships and other entities in which interests have been gifted to family members so we can determine whether any transfers may be subject to the *Powell* decision, and, if applicable, recommend remedial action.

2019 Gift Tax Returns

Gift tax returns (IRS Form 709) for gifts made in 2019 are due on Tuesday, April 15, 2020. This deadline may be extended to October 15, 2020, with a timely filed request for an automatic extension to file 2019 income tax returns. However, the extension does not extend the time to pay any gift taxes that may be due.

For clients who have grantor retained annuity trusts ("GRATs") and/or qualified personal residence trusts ("QPRTs") that terminated in 2019, consideration should be given regarding whether or not to file a gift tax return to allocate the federal generation-skipping transfer tax ("GST") exemption to take advantage of the increased exemption amounts.

How do these changes affect existing Hopkins & Carley estate planning documents?

Clients may wish to consider updating their current estate planning documents to reflect changes made by the SECURE Act, the 2017 Act and/or the *Estate of Powell*. For example, by utilizing the portability rules, many married couples can simplify the administration of their revocable living trust after the first spouse's death. Also, *it is imperative that estate plans designed to allocate or distribute amounts based on the available estate tax exemption and/or GST exemption be reviewed to ensure that the new, higher exemption levels are consistent with the original objectives of the plan*. Additionally, those with significant value in traditional IRAs may want to consider advanced planning techniques in light of the SECURE Act.

We typically recommend a review of estate planning documents with one of our attorneys every two or three years. Reasons that clients may need modify their plan include:

- An increase or decrease in the size of their estate;
- Acquisitions of major assets including out of state real property and life insurance;
- Changes in marital status of clients or their children (marriage, divorce or separation);
- Additions to their family through birth, adoption or marriage; or
- New thoughts about who should administer funds for their heirs, or how and when their heirs should receive their estate.

As always, we look forward to assisting new and current clients with their estate planning needs. If you have any questions or would like to discuss any of the above issues in more detail, please feel free to contact any one of our Private Client Services attorneys.