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Estate Planning Affected by Recent Events: Planning for Predictable Estate Tax Increases; Tax Repercussions of COVID-19-Driven Workplace Trends: Planning for Section 529 Accounts After COVID-19 Effects on Higher Education

by Michael D. Whitty

A FREEBORN & PETERS LLP CLIENT ALERT



Estate Planning in the first half of 2020 continues to be impacted by recent events, current trends, and contingency planning. This Client Alert provides information on three hot topics:

1. Planning for Predictable Reductions in **Estate and Gift Tax Exemptions**, Whether Or Not Congress Adopts Candidates' Proposals
2. Tax Repercussions of COVID-19-Driven **Changes to Workplaces, Careers**
3. Planning for **Section 529 Accounts** Due To COVID-19 Effects on Higher Education

Our two preceding Client Alerts covered the following topics, among others, that continue to be of interest:

- [Market Conditions Affecting Valuations for Estate and Gift Tax Transfers, Economics of Life Insurance Policies](#)
- [Potential Estate and Gift Tax Savings From Intra-Family Loans and Loan Refinancing using Low Interest Rates](#)
- [The Great GRAT Giveaway: Grantor Retained Annuity Trusts \("GRATs"\) Are Ideally Suited For Current Market and Interest Rate Conditions](#)
- [Formalities of Execution of Health Care Documents and Estate Plans Adapted to Reflect Social Distancing Required by COVID-19](#)

If any of these topics are of interest or concern for you, we look forward to discussing them with you. Please contact one of the Freeborn & Peters LLP attorneys listed below.

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1. Planning for Inevitable Reductions in Estate and Gift Tax Exemptions and Possible Increases in Estate Tax Rates

In 2020, the federal unified estate and gift tax exemption is \$11,580,000 per person (double for a married couple), with built-in inflation adjustments each year. However, under current law, that exemption is scheduled to be **reduced by half** at the end of 2025 (to “sunset” the increase from the Tax Cuts and Jobs Act of 2017). Given the recent swelling of the federal deficit and debt due to COVID-19 relief spending, the chances that the sunset will be repealed or postponed are low, no matter which party controls Congress and the White House.

Several presidential candidates have proposed reducing the exemption by half, *or more*, even sooner than the scheduled 2025 sunset (see **Table 1** on page 3). Such a change could go into effect as early as January 1, 2021, if one of those candidates is elected and has a willing Congress with whom to work. Other proposals by these candidates would increase the estate tax flat rate, add additional estate tax rates at higher brackets, impose an annual wealth tax, eliminate the basis step-up at death, or even impose **capital gains taxes at death**. (Under current law, transfers at death are generally not a capital gain event, and the transferee’s basis of the transferred assets is marked-to-market as of the transferor’s date of death.)

As of the date of this Client Alert, former Vice President Joe Biden is the presumptive nominee for the Democratic Party. However, he has formed a “Unity Task Force” with contender Senator Bernie Sanders, and Senator Elizabeth Warren remains in contention for their ticket, so their proposals may ultimately influence or become part of the Democrats’ platform.

The safest prediction is that the federal estate and gift tax exemption *will* be reduced; the only uncertainties are *when* and *by how much* the exemption will come down. Taxpayers who currently face estate taxes, or who would after a reduction in the unified exemption, should accept that and plan accordingly.

Under recent regulations, the Treasury Department has confirmed that it will not apply a punitive “clawback” approach to the estates of donors who used their exemption while it is high (as with the current exemption amount), but then died after the exemption was reduced (whether by the “sunset” provision of current law, or by another reduction in the exemption due to a future act of Congress). Therefore, donors who use their full estate and gift tax exemption while it is higher will not be punished if the exemption is reduced later.

The prospects for the proposals to impose capital gains at death are not nearly as certain as a reduction of the estate and gift tax exemption. Such a proposal would be critiqued as having enormous unintended consequences, such as the effect on the markets of a not-insignificant number of taxpayers no longer needing to retain assets to obtain the step-up in basis, and the effects of capital gains realization on investment partnership interests with negative tax basis. Furthermore, planning to address such a change would not necessarily have to be completed by the end of 2020. Nonetheless, the prospect of such a significant change should be addressed if it appears possible after the election results.

While we do not suggest that taxpayers rush into plans to use their currently high gift tax exemption, waiting until Election Day (November 3, 2020) to even think about or discuss the subject with an estate planner could lead to a “rush job” at best, or an incomplete or inaccurate transfer at worst. Taxpayers would be better off having a preliminary conversation with their estate planner earlier in the year to establish a plan of action to be implemented after Election Day but before year-end. This conversation may require only 45 to 60 minutes to develop a plan that would identify in advance:

- The purpose and beneficiaries for the transfer;
- The trust or trusts to be used, or the outline for a new trust if no existing trust is ideal for the intended purpose;
- The approximate amount, type, and source of the assets to be transferred, and whether appraisals will be required, and
- The structure of the transfer (as a direct gift, a loan or installment sale, through a GRAT, or by some combination), and whether valuation adjustment clauses should be included to mitigate the risk of a gift tax audit adjustment.

Table 1: Current Law Compared With Candidate Proposals

Category	Current Law	Biden Proposals	Sanders (or Warren) Proposals*
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*Sanders and Warren proposals are included because they may influence the Democratic Party platform, with Sanders having formed a “Unity Task Force” with Biden’s campaign and Warren remaining in contention for a spot on the ticket.

Federal Transfer Taxes (Estate, Gift, and Generation-Skipping Transfer Taxes)

Lifetime Exemption from Estate and Gift Tax	\$11,580,000 <i>(Sunset after 2025: Cut by 50%)</i>	\$3,500,000 <i>(same as 2009)</i>	<u>\$3,500,000</u>
GST Tax Exemption		\$3,500,000	\$1,000,000
Transfer Tax Rate	40%	45% to 77%	<u>45% to 90%</u>
Techniques Restricted	<i>Intra-family preferred interests and lapsing restrictions</i>	<i>No proposal yet, but hasn't ruled out the ideas proposed by the Obama administration</i>	<i>No proposal yet, but hasn't ruled out the ideas proposed by the Obama administration</i>
Appreciated Property Transferred at Death	Step-up in basis even if no estate tax due; transfer at death not a capital gain event	<u>Step-up in basis eliminated and capital gains at death or upon gifts**</u>	<u>Step-up in basis eliminated and capital gains at death**</u>

**Above proposals for capital gains at death would also be subject to higher capital gains tax rates, as shown below.

Wealth Tax	None	No proposal yet, but hasn't ruled out the idea	<u>Sanders Proposal:</u> 1% up to 8% Minimum thresholds \$16MM indiv./ \$32MM couple <u>Warren proposal:</u> 2% to 3% per year <u>above a \$50MM threshold</u>
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Individual Income Taxes

Range of Rates	10% - <u>37%</u> + 3.8% Med Surtax on Investment Income	10% - <u>39.6%</u> <i>(same top rate as 2009)</i>	10% - <u>56%</u> <u>+4% surtax >\$29k</u> for health care, education spending
Capital Gains and Qualified Dividends	10%, 15%, or 20%	<u>Ordinary Income Rates Would Apply</u>	<u>Ordinary Income Rates Would Apply</u>

2. Tax Repercussions of COVID-19-Driven Changes to Workplaces

The quarantines, lockdowns, and “Stay-at-Home” orders resulting from the COVID-19 pandemic have affected many workers and workplaces in ways that will have lasting impacts beyond the current conditions.

- Many professionals and staff have grown accustomed to working from home. Some cities are experiencing a “Back to the ‘Burbs” trend where professionals and staff will come to a downtown office only occasionally.

- Many employers are discovering the advantages of having employees work from home, and may encourage workers to continue doing so to address health concerns or achieve cost savings from reduced office space requirements.
- Some workers now searching for new employment, or taking early retirement packages, will be working from home as they find new employment, consulting opportunities, or director positions.

These broad trends will have significant tax planning and financial planning implications and opportunities, for which our estate planning attorneys can assist in the following ways:

- Professionals and staff transitioning to remote work may no longer need to reside in the state where their employer's home office is located. An employee might be able to change his or her tax domicile to a state with lower or zero income taxes, and only have to pay tax at the higher rate of the employer's home office state for those days actually present in that state. We continue to help clients plan for and document proof of their change of tax domicile to lower-tax states.
- Younger families seeking to buy homes in the suburbs could benefit from gifts or low-interest loans to assist. (Note that loans typically can't be used to provide down payments, and borrowers have to certify that their down payment is their own funds not subject to repayment.) Current gift and estate tax conditions and low interest rates provide parents an opportunity to help their children achieve home ownership at a much lower cost. We continue to help parents choose the right approach and structure and document their assistance for efficiency and to minimize gift taxes.

3. Planning for Section 529 Accounts Due To COVID-19 Effects on Higher Education

Parents with children in college or approaching college-age are personally experiencing or have likely read recent news stories about the effects of COVID-19-related quarantines on college and university campuses. Most colleges moved to online classes in the spring term of 2020 at around the time of their spring break or shortly thereafter. Some colleges and universities plan to resume in-person classroom instruction in the fall of 2020 (e.g., Notre Dame, University of Illinois), but others have already announced plans to hold all of their classes online this fall (e.g., California State University system). Another group continues to take a "wait and see" approach and have not yet decided (e.g. University of California system) or may take a hybrid approach. As a consequence, many students—including incoming freshmen—are questioning the value of paying full tuition for online classes without the academic benefits of in-person classes and the social benefits of campus life and clubs, and are considering taking the fall semester off, accelerating their education with online summer school courses as this summer's internships are cancelled, or even taking a "gap year."

Section 529 accounts became available in 2001 and have become one of the most popular vehicles for parents and grandparents to save for a child's or grandchild's college education on a tax-preferred basis. Parents who have made significant investments in saving for college using Section 529 accounts should consider three questions at this time:

1. Will the Section 529 Account still be needed, and if so, when?
2. Has the investment time horizon changed?
3. Should the investment mix be changed?

Continuing Need for Section 529 Account. As a consequence of changes to campus life and the potential for poorly endowed colleges to close entirely, there will be a few college students who decide not to return to college immediately, or attend a compatible local college, and a few high school graduates who decide not to attend college at all. This may be a small fraction of the total college student population, but planning for Section 529 accounts earmarked for those students would need to change significantly.

- If a parent or grandparent is still the owner of the Section 529 account earmarked for a student who will no longer be attending college, it is possible to change the beneficiary to another family member (e.g. the original beneficiary's sibling, cousin, or descendant).
- Even if the Section 529 account will still be needed for education, the account owner should consult a financial planner to analyze whether the reduced cost of an online-only semester or two (saving room and board, even if that institution does not reduce tuition) would allow regular contributions to be reduced or postponed.
- If there is no other family member who might be a substitute beneficiary, the account owner should consult a financial

planner for an analysis of other options. As one example, the account could function as a supplemental retirement account; the rules on how Section 529 withdrawals are taxed are favorable compared to variable annuities, and that advantage largely offsets the 10% surtax on withdrawals for non-educational purposes.

Change of Investment Time Horizon. If the student beneficiary will take a gap year or longer, the account owner should consider this as a longer time horizon for the Section 529 account's investments and consult with their financial advisor about adjusting the investment mix accordingly. For example, some Section 529 plans offer target date investment funds structured to maximize growth until the beneficiary is expected to enter college, then preserve value while the beneficiary is in college. If the student beneficiary will take a gap year, a financial advisor might recommend changing to a fund that defers the transition from growth to preserving value.

Change of Investment Mix to Reflect Market Conditions. Current market conditions have depressed public equity markets (although there has been some rebound) while lowering interest rates significantly. Owners of Section 529 accounts should consult with a financial advisor and consider changing the mix of investments in the account to adjust to changed circumstances.

Freeborn's Response to COVID-19

Freeborn & Peters COVID-19 Task Force, with dozens of COVID-19 related Client Alerts and links:

<https://www.freeborn.com/practice/covid-19>

Bill Russell's white paper on client result using a GRAT:

<https://www.freeborn.com/perspectives/real-life-example-transferring-growth-without-gift-tax>



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Michael Whitty is a Partner in the Corporate Practice Group. He concentrates his practice in estate planning, taxation, and estate and trust administration. Michael represents business owners, principals of venture capital and private equity funds, key executives, investors, and other highnetworth individuals in planning for the preservation and transfer of their wealth.

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