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TRUSTS AND ESTATES GROUP

2020

PLANNING UPDATE

2020 Estate & Gift Tax Inflation Adjustments

Several important federal gift and estate tax exemptions are adjusted periodically to reflect the rate of inflation. The IRS has announced the following adjustments for 2020:

- **Basic Exclusion** – For 2020, the basic estate, gift and generation-skipping exclusion amount is $11,580,000. The basic exclusion represents the amount that can be transferred, during lifetime or at death, free of estate tax, gift tax or generation-skipping transfer (GST) tax, as the case may be. This represents the base exclusion amount of $10,000,000, plus an inflation adjustment.
- **Exclusion for Lifetime Gifts to Non-Citizen Spouse** – Lifetime gifts to a spouse who is a U.S. citizen are not subject to gift tax regardless of the amount. Lifetime gifts to a spouse who is not a U.S. citizen are subject to gift tax to the extent the gifts exceed the authorized exclusion in any year. For 2020, this exclusion is $157,000.
- **Annual Gift Tax Exclusion** – The annual exclusion amount for gifts of present interests is unchanged at $15,000. The marginal estate, gift and GST tax rates remain at 40%.

It is important to note that on January 1, 2026, the $10 million base exclusion amount will be reduced to $5 million, plus an inflation adjustment. This reduction is referred to as "sunset." The portion of the exclusion that will be lost on sunset is referred to as the "bonus" exclusion. After sunset, it is estimated that the inflation-adjusted exclusion amount will be in the range of $6 million - $7 million.

As noted in our 2019 newsletter, a wealthy taxpayer may wish to make a large lifetime gift to take advantage of the bonus exclusion before sunset. There was concern that, after sunset, a taxpayer may owe tax on the portion of the gift that was covered by the bonus exclusion (so-called "clawback"). The United States Treasury has confirmed through regulations that clawback will not apply, thus removing this potential deterrent to large pre-sunset gifts. (These regulations apply for gift and estate tax purposes; unfortunately, they do not address the GST tax, but we expect that a similar approach will be applied to large gifts covered by the GST tax exclusion and hope that the Treasury will issue similar regulations.) For a wealthy taxpayer to "use it or lose it," the cumulative value of her pre-sunset gifts must exceed the value of the exclusion available at death post-sunset. For example, if a taxpayer gifts $8 million to a child before sunset, a gift fully covered by the exclusion, and then dies after sunset and when the exclusion is $6.5 million, she will have shielded $1.5 million of her estate from tax under the bonus exclusion. If the pre-sunset gift was $11 million, she will have shielded $4.5 million of her estate from tax under the bonus exclusion. The larger the gift, the greater use of the bonus exclusion.

Of course, there are many other tax and non-tax considerations in making large gifts like this. Also, it is important to note that sunset may be accelerated if Democrats gain control of the White House and/or Congress after the 2020 elections. Feel free to contact us for more information.

Changes to Retirement Account Rules

Beginning January 1, 2020, the SECURE Act (Setting Every Community Up for Retirement Enhancement) significantly changed the rules regarding retirement accounts.

Prior to the Act, you could leave your IRA to an individual beneficiary who would then be able to take distributions from the IRA in annual installments over his life expectancy. This allowed the income taxes attributable to the IRA distributions to be paid in the same annual installments over the beneficiary's life expectancy term rather than paid in one lump sum. This was referred to "stretching" the IRA.

Under the Act, your IRA beneficiary is no longer allowed to stretch the IRA over his life expectancy. Instead, your IRA beneficiary must distribute the full IRA to himself within 10 years of your death. Along with these accelerated distributions are accelerated payments of the associated income taxes.

There are several exceptions to the new 10-year rule if your beneficiary (1) is your spouse, (2) is less than 10 years younger than you, (3) is under age 18 or (4) is disabled or chronically ill. In these cases, the stretch approach or a hybrid stretch approach is still possible. If your beneficiary is a "conduit" or "accumulation" trust, the IRA stretch benefits for which these trusts were designed are no longer available.

If you have not designated a beneficiary of your IRA, if your "estate" is the beneficiary or if a trust (other than a "conduit" or "accumulation" trust) is the beneficiary, the full IRA must generally be distributed (and the associated income taxes paid) within 5 years of your death.

Other changes made by the Act, not all pertaining to IRAs, include:

- The date by which you must begin taking distributions from your IRA (the so-called "required beginning date") has been extended to April 1 of the year following the year in which you turn 72. If you turned 70½ in 2019, you are subject to the old rule and your required beginning date is April 1, 2020.

- If you have earned income, you may contribute to an IRA even if you are over age 70½.

- You may take early distributions from your IRA to assist with the expenses of the birth or adoption of your child. Previously, such early distributions were subject to a 10% penalty.

- You may now use funds in a 529 education savings account to repay certain student loans incurred by the 529 account beneficiary, capped at $10,000 each. Such funds may also be used to pay for certain registered apprenticeship programs.

- Under prior law, the "kiddie tax" (income tax on your child's unearned income) was imposed at the compressed brackets and rates applicable to trusts. Now, the kiddie tax is imposed at your marginal income tax rate as the parent. You may amend your 2018 and 2019 tax returns to retroactively apply this new rule.

Of course, there are nuances in the new rules and exceptions to the exceptions, so please contact us if you'd like to review your particular circumstances so that we can advise you further.

Assisting a Child with the Purchase of a Home

The dream of owning your own home in California, especially in the Bay Area, has become increasingly difficult. Many individuals, even those with well-paying jobs, are still unable to afford the purchase of a home. As a result, many clients ask us how they can assist a child with the purchase of a home, whether by assisting with the down payment or with the entire purchase price. Here are a few options:

One option is for you to loan money to a child. Structuring the terms of the loan can be quite flexible. For example, you can (1) choose a specific due date for the loan, or make the loan payable upon your demand, (2) make the loan interest-only with a balloon paymen of principal, or choose to amortize the loan so that some principal is made with each payment, and (3) make the loan secured or unsecured (we recommend a secured loan). One important requirement under any loan structure is that the interest rate must be no less than "applicable federal rate" (AFR). The AFR, which changes monthly and depends on the length of the loan, is the minimum interest rate you can use to avoid adverse tax consequences. Even though the loan is an enforceable contract between you and your child, it is possible to forgive your child's payments under the loan (subject to possible gift tax consequences). Even if interest payments are forgiven, you will still need to report and pay the income taxes on the interest as if it was paid to you. Before you loan money to your child, you should carefully think about your "exit strategy" if your child fails to make payments on the loan – would you be comfortable extending the loan indefinitely or foreclosing on the home that secures the loan?

Another option is for you to gift money to a child. Depending on the gift amount, it may be covered by your annual gift tax exclusion or you may need to report the gift on a gift tax return (IRS Form 709) and use a portion of your basic exclusion amount (see related article in this newsletter for current exclusion amounts). If the gift is made directly and outright to your child, your child would purchase and own the home. If the gift is made to a trust for your child's benefit, the trust would purchase and own the home and, generally, your child may reside in the home without payment of rent. The use of a trust adds complexity, but, if the trust is structured properly, it provides added protection if your child may face liability to a creditor or spouse, or if your child simply needs assistance with the management of the home.

Another option is for you to purchase some or all of the home yourself. If you do this, you will be on title to the home and have all responsibilities, obligations and liabilities of a homeowner. At some point, you likely will want to transfer ownership of the home to your child, and you could do this by gifting fractional interests in the home to your child over the course of several years or by gifting the entire home in a single transaction. Of course, gift tax issues must be considered, as well as issues of rent payment, payment of expenses, etc. A written lease or co-ownership agreement between you and your child is recommended to ensure that your expectations are aligned with your child's expectations.

Regardless of which option works best for you, you should review your estate plan as part of the project. In most cases, your estate plan will need to be updated to take into account the assistance provided to your child. For example, you may need to provide an equalizing gift to another child, or a provision cancelling any remaining balance on a loan at your death.
We recommend that if you plan to assist a child with the purchase of a home, you schedule an appointment with us to discuss your options and the related estate planning and tax consequences.

California State Domestic Partnership Expanded

On January 1, 2020, a new law took effect expanding the availability of California state domestic partnership registration for all California couples, regardless of age and sexual orientation, so long as the couple is otherwise eligible to be married.

Prior to the new law, only (1) opposite sex couples where at least one person was over age 62 years and (2) same sex couples of any age who were otherwise eligible to be married were permitted to register in California as state domestic partners. California state domestic partnerships were originally made available so that these groups could secure certain legal rights afforded to married couples. After the U. S. Supreme Court established the constitutional right to marry for same-sex couples, some states eliminated their state domestic partnership registry, but California did not.

A California state registered domestic partnership is treated as a marriage for all purposes under California law, including for California property taxes, California income taxes, inheritance, and community-separate property. A California domestic partnership is not treated as a marriage under federal laws (e.g., for federal income tax, federal estate and gift tax, military and federal pension benefits, or immigration). However, keep in mind that in filing federal income tax returns, California state domestic partners earning community property must typically file as single or head of household and split their community property income on a separate spreadsheet similar to that used by married couples filing separately.

Now, the more widespread availability of state registered domestic partnerships in California is expected to have a significant impact on the decision to marry for opposite sex couples. On the one hand, couples who choose to register as state domestic partners instead of marrying may benefit from lower federal income taxes, especially when both persons earn similar incomes and/or are raising minor children. On the other hand, couples who make this decision will lose some federal tax benefits only provided to married couples, such as the so-called "double basis step-up" for federal income tax purposes, the unlimited estate tax marital deduction, and portability of any unused estate tax exemption.

If you are considering a California state registered domestic partnership, please keep in mind:

- California state domestic partnership registration is separate from domestic partnership registrations at the county or city level, or through your or your partner's employer, all with separate requirements, benefits, and responsibilities.
- You will need to structure your estate plan to take into account the different obligations, rights and benefits under California law as compared to federal law.
- California will recognize as a state registered domestic partnership a substantially similar arrangement from another state, such as a Vermont civil union.

Feel free to contact us if you have further questions or would like to learn more.

The Small Estate Limit Has Increased

Property in a small estate may be transferred upon a decedent's death in California without a formal probate proceeding. An estate is a "small estate" when the gross value of the property in California, after statutory exceptions, does not exceed a certain amount. This amount has been increased in 2020 from $150,000 to $166,250. The following assets are excluded in

determining the $166,250 limit: (1) automobiles, mobile and motor homes and boats registered through the Department of Motor Vehicles, (2) assets that pass on the decedent's death by beneficiary designation, such as life insurance, retirement accounts and equity-compensation, (3) assets held in trust, and (4) assets jointly owned "with right of survivorship."

An heir or beneficiary may collect the decedent's property in a small estate by way of a written affidavit. We refer to this as the small estate affidavit. In addition to those decedents who do not own more than the specified amount at the time of death, in our experience, the small estate affidavit is most commonly used to collect an account that was not transferred to a revocable living trust during the decedent's lifetime or when no effective beneficiary designation is in place for life insurance or retirement accounts. In other words, it can be used in conjunction with other probate avoidance techniques.

Beginning in 2022, the small estate amount will be adjusted every three (3) years based on a consumer price index. In the past, many financial institutions have provided a small estate affidavit to the beneficiary seeking to collect an asset but if not, it is a relatively simple form that can be prepared and to which a death certificate is attached.

The Expanding Definition of Parentage

Since 2014, under California Senate Bill 274, children are legally permitted to have more than two parents. The law was prompted by a 2011 California court decision in which two legal parents, no longer in a relationship, were both unable to care for their child. A third person, who had a parent-like relationship with the child, raised the child as his own natural child. Ultimately, the court did not recognize all three persons as legal parents but invited the legislature to reconsider the two-parent rule.

Following this case, California law was changed so that more than two persons who claim parentage can be legal parents under certain circumstances, such as when recognizing only two parents would be detrimental to the child. The expansion of the definition of parentage can have an impact on estate planning and estate and trust administration. For example, it can affect who is entitled to inherit as a parent, a child, or a more remote descendant, as well as who is entitled to receive notice of trust and probate proceedings. Also, the new rules give rise to petitions for legal adoption of a child by a third or fourth parent.

In reviewing estate plan, you may want to talk with your trusts and estates attorney about:

- Whether to update references to your children to include (or exclude) an individual who may be deemed your child under the new rules;
- Whether there might be another person who could be considered your parent;
- Whether there might be another person who could be considered your child's parent; and
- Whether there might be another person who could be considered the parent of someone else named in your estate plan.

If you have questions, please reach out.

Founded in 1914 in Palo Alto, LAKIN SPEARS, LLP is a law firm built on a long tradition of prompt, efficient and value-added legal service to our clients throughout the Bay Area. The firm specializes in handling trusts and estates, family law, real estate and business matters.

The Trusts & Estates Group provides the full range of legal services in the areas of estate planning, estate and trust administration, gift and philanthropic planning, incapacity planning, guardianships, conservatorships, estate, trust and conservatorship litigation, and estate and gift tax return preparation.

This publication is for general information only and is not specific legal advice or a substitute for advice from qualified counsel.

Please contact us if you have any questions about the information in this newsletter.

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