THE ESTATE PLANNER

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Shumaker, Loop & Kendrick, LLP

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What's a clawback — and should you be worried about it?

By temporarily doubling the gift and estate tax exemption amount, the Tax Cuts and Jobs Act created an historic opportunity for affluent families to shelter wealth from transfer taxes through lifetime giving. But some families are concerned that, if they take advantage of this opportunity, a portion of those gifts may be "clawed back" into their estates and be subject to estate taxes when the exemption amount is reduced.

Fortunately, the IRS has issued proposed regulations that ease these concerns. As of this writing, the regs haven't yet been finalized, but informal IRS guidance provides some assurances that the clawback likely won't be an issue.

A limited time offer

For 2019, the exemption amount stands at an inflation-adjusted $11.4 million ($22.8 million for married couples), but those figures are scheduled to revert to $5 million and $10 million, respectively, on January 1, 2026 (adjusted for inflation). So, there's a limited time to make the most of the increased exemption. By making additional exempt lifetime gifts before the higher exemption amount expires, you can remove substantial assets — together with any future appreciation in their value — from your taxable estate.

Concerns about clawbacks stem from the mechanics of the estate tax computation.

As you consider this strategy, however, be sure to weigh the gift and estate tax savings against potential income tax costs. Unlike transfers at death, lifetime gifts don't enjoy the stepped-up basis that allows inheritors of appreciated assets to reduce or eliminate capital gains taxes.

Beware the clawback

Concerns about clawbacks stem from the mechanics of the estate tax computation. The process is complex and involves multiple steps, but, in a nutshell, a literal reading of the tax code requires you to add back previous taxable gifts (including gifts that were within the applicable exemption amount when made) and then apply the exemption amount in effect in the year of death.

Suppose, for example, that Frank makes $11 million in taxable gifts in 2019, when the exemption amount is $11.4 million, and dies with a $4 million taxable

IRS guidance offers peace of mind

Taxpayers can't rely on the proposed regulations until they're finalized. But statements by the IRS in informal guidance indicate that a clawback is unlikely to undo the benefits of lifetime gifts that take advantage of the higher exemption amount.

For example, the IRS recently posted a FAQ on its website, entitled "Making large gifts now won't harm estates after 2025." According to the FAQ, the proposed regulations "clarified that individuals taking advantage of the increased gift tax exclusion amount in effect from 2018 to 2025 will not be adversely impacted after 2025 when the exclusion amount is scheduled to drop to pre-2018 levels."

A disclaimer warns readers that the FAQ can't be relied on as legal authority. Nevertheless, the document reflects the IRS's position on this issue and provides some peace of mind to those contemplating large gifts.

estate in 2026. For purposes of this example, assume that Frank hadn't previously used any of his exemption and that his exemption wasn't affected by a deceased spouse's unused exemption or other adjustments. Also assume that the exemption amount in 2026 has dropped to $6 million and the estate tax rate is 40% throughout the example.

To compute its estate tax liability, Frank's estate must add back the $11 million in gifts, increasing his taxable estate to $15 million, and then subtract $6 million (the applicable exemption amount in 2026) to arrive at a taxable amount of $9 million. The estate tax is 40% of $9 million, or $3.6 million. In effect, estate tax is imposed on the portion of Frank's 2019 gifts that were sheltered by the increased exemption amount allowable at that time.

Proposed regulations

The IRS proposal would avoid the above result by providing that, in situations like Frank's, the exemption amount would be the *greater* of:

1) the exemption amount used to shelter gifts made from 2018 through 2025, or

2) the exemption amount applicable in the post-2025 year of death.

Going back to our example, under the proposed regulations, the tax liability on Frank's estate would be calculated using an $11 million exemption amount (the amount he used to shelter his 2019 gifts). The estate tax would be 40% of $4 million ($15 million - $11 million), or $1.6 million. Notice that the difference between this tax and the tax that would have been owed absent the proposed regulations is $2 million, which is equal to the tax on the $5 million that was clawed back in the original example.

Act soon

Six years may seem like plenty of time, but lawmakers could decide to reduce the exemption amount even sooner, particularly if next year's election changes the political makeup of Congress or the White House. Given this uncertainty, it's a good idea to act quickly if you wish to take advantage of the higher exemption.

If you're concerned about a potential clawback, keep in mind that the IRS seems inclined to adopt anticlawback regulations. (See "IRS guidance offers peace of mind" above.) Plus, even with a clawback there are advantages to making lifetime gifts now, because they allow you to avoid gift and estate taxes on any future appreciation. ▮

Estate planning and your art collection

If you're an art collector, it's critical for your estate plan to address your collection separately from other types of assets. Investments in artwork may be motivated in part by financial gain, but for most collectors the primary motivation is a passion for the art itself.

As a result, managing these assets involves issues that aren't presented by purely financial assets. Naturally, you'll want to preserve the value of your collection and avoid unnecessary taxes, but you'll also be keenly interested in how your collection is managed and displayed after you're gone.

Know the collection's value

It's vitally important to have your collection appraised periodically by a professional. The frequency depends in part on the type of art you collect, but generally it's advisable to obtain an appraisal at least every three years, if not annually.

Regular appraisals give you an idea of how the collection is growing in value and help you anticipate tax consequences down the road. Also, most art donations, gifts or bequests require a "qualified appraisal" by a "qualified appraiser" for tax purposes.

In addition, catalog and photograph your collection and gather all appraisals, bills of sale, insurance policies and other provenance documents. These items will be necessary for the recipient or recipients of your collection to carry out your wishes.

Review your options

Generally, there are three options for handling your art collection in your estate plan: Sell it, bequest it to your loved ones, or donate it to a museum or charity. Let's take a closer look at each option:

1. If you opt to sell, keep in mind that capital gains on artwork and other "collectibles" are taxed at a top rate of 28%, compared to 20% for other types of assets. Rather than selling the collection during your lifetime, it may be preferable to include it in your estate to take advantage of the stepped-up basis, which allows your heirs to reduce or even eliminate the 28% tax. For example, you might leave the collection to a trust and instruct the trustee to sell it and invest or distribute the proceeds for the benefit of your loved ones.

2. If you prefer to keep your collection in the family, you may opt to leave it to your heirs. You could make specific bequests of individual artworks to various family members, but there are no guarantees that the recipients will keep the pieces and treat them properly. A better approach may be to leave the collection to a trust, LLC or other entity — with detailed instructions on its care and handling — and appoint a qualified trustee or manager to oversee maintenance and display of the collection and make sale and purchasing decisions.

3. Donating your collection can be an effective way to avoid capital gains and estate taxes and to ensure that your collection becomes part of your legacy. It also entitles you or your estate to claim a charitable tax deduction. To achieve these goals, however, the process must be handled carefully. For example, to maximize the charitable deduction, the artwork must be donated to a *public* charity — such as a museum or university with that status — rather than a private foundation. And the recipient's use of the artwork must be related to its tax-exempt purpose. In other words, the recipient would have to exhibit it or use it for art education, for example, rather than selling it. Also, if you wish to place any conditions on the donation — such as specifying where the collection can or cannot be displayed or including your name on signage accompanying the artworks — you'll need to negotiate the terms with the recipient before you deliver the items.

If you plan to leave your collection to loved ones or donate it to charity, it's critical to discuss your plans with the intended recipients. If your family isn't interested in receiving or managing your collection or if your charitable beneficiary has no use for it, it's best to learn of this during your lifetime so you have an opportunity to make alternative arrangements.

Seek professional help

Work with an advisor who has experience with the unique estate planning issues surrounding works of art. He or she can help ensure that your prized art collection gets the treatment it deserves and that its ultimate disposition is accomplished in a tax-efficient manner.

ABLE accounts and special needs trusts

2 options for families with disabled loved ones

If you have a family member who's disabled, financial and estate planning can be tricky. You don't want to jeopardize his or her eligibility for means-tested government benefits such as Medicaid or Supplemental Security Income (SSI). A special needs trust (SNT) is one option to consider. Another is to open a Section 520A account, often referred to as an ABLE account, because it was created by the Achieving a Better Life Experience (ABLE) Act.

ABCs of an ABLE account

The ABLE Act allows family members and others to make nondeductible cash contributions to a qualified beneficiary's ABLE account, with total annual contributions limited to the federal gift tax annual exclusion amount (currently, $15,000). To qualify, a beneficiary must have become blind or disabled before age 26.

The account grows tax-free, and earnings may be withdrawn tax-free provided they're used to pay "qualified disability expenses." These include health care, education, housing, transportation, employment training, assistive technology, personal support services, financial management and legal expenses.

An ABLE account generally won't affect the beneficiary's eligibility for Medicaid and SSI — which limits a recipient's "countable assets" to

$2,000 — with a couple of exceptions. First, distributions from an ABLE account used to pay housing expenses are countable assets. Second, if an ABLE account's balance grows beyond $100,000, the beneficiary's eligibility for SSI is suspended until the balance is brought below that threshold.

Anyone can establish an SNT, but ABLE accounts are available only if your home state offers them, or contracts with another state to make them available.

ABLE vs. SNT

Here's a quick review of the relative advantages and disadvantages of ABLE accounts and SNTs:

Availability. Anyone can establish an SNT, but ABLE accounts are available only if your home state offers them, or contracts with another state to make them available. Also, as previously noted, ABLE account beneficiaries must have become blind or disabled before age 26. There's no age limit for SNTs.

Qualified expenses. ABLE accounts may be used to pay only specified types of expenses. SNTs may be used for any expenses the government doesn't pay for, including "quality-of-life" expenses, such as travel, recreation, hobbies and entertainment.

Tax treatment. An ABLE account's earnings and qualified distributions are tax-free. An SNT's earnings are taxable.

Contribution limits. Annual contributions to ABLE accounts currently are limited to $15,000, and total contributions are effectively limited to $100,000 to avoid suspension of SSI benefits. There are no limits on contributions to SNTs, although contributions that exceed $15,000 per year may be subject to gift tax.

Investments. Contributions to ABLE accounts are limited to cash, and the beneficiary (or his or her representative) may direct the investment of the account funds twice a year. With an SNT, you can contribute a variety of assets, including cash, stock or real estate. And the trustee — preferably an experienced professional fiduciary — has complete flexibility to direct the trust's investments.

Medicaid reimbursement. If an ABLE account beneficiary dies before the account assets have been depleted, the balance must be used to reimburse the government for any Medicaid benefits the beneficiary received after the account was established. There's also a reimbursement requirement for SNTs. With either an ABLE account or an SNT, any remaining assets are distributed according to the terms of the account or the SNT.

Examine the differences

When considering which option is best for your family, remember the key differences: An ABLE account may offer greater tax advantages, while an SNT may offer greater flexibility. Your estate planning advisor can help answer your questions. ■

ESTATE PLANNING RED FLAG

Your will or trust lacks clarity

Precise language is critical in wills, trusts and other estate planning documents. A lack of clarity is an invitation to litigation, as demonstrated by the ongoing dispute between Tom Petty's widow and his two daughters from a previous marriage.

Details of the musician's estate plan aren't entirely clear. But it appears that his trust appointed his widow as "directing trustee," while providing that she and his daughters were entitled to "participate equally" in the management of his extensive music catalog and other assets. Unfortunately, the trust failed to spell out the meaning of equal participation, resulting in litigation between Petty's widow and daughters over control of his assets.

There are several plausible interpretations of "equal participation." One interpretation is that each of the three women has an equal vote, giving the daughters the ability to rule by majority. Another interpretation is that each has an opportunity to participate in the decision-making process, but Petty's widow has the final say as directing trustee. Yet another possibility is that Petty intended for the women to make decisions by unanimous consent.

Ultimately, it will be up to the courts to provide an answer based on evidence of Petty's intent. But the time, expense and emotional strain of litigation could have been avoided by including language in the trust that made that intent clear.

If you're planning your estate, the Petty case illustrates the importance of using unambiguous language to ensure that your wishes are carried out. And if you anticipate that one or more of your beneficiaries will perceive your plan as unfair, it's a good idea to sit down with them to explain your reasoning. This sort of discussion can go a long way toward avoiding future disputes.

Experience. Responsiveness. Value.

At Shumaker, we understand that when selecting a law firm for estate planning and related services, most clients are looking for:

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- A creative and imaginative approach that focuses on finding solutions, not problems.
- Accessible attorneys who give clients priority treatment and extraordinary service.
- Effectiveness at a fair price.

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Estate planning is a complex task that often involves related areas of law, as well as various types of financial services. Our clients frequently face complicated real estate, tax, corporate and pension planning issues that significantly impact their estate plans. So our attorneys work with accountants, financial planners and other advisors to develop and implement strategies that help achieve our clients' diverse goals.

Shumaker has extensive experience in estate planning and related areas, such as business succession, insurance, asset protection and charitable giving planning. The skills of our estate planners and their ability to draw upon the expertise of specialists in other departments — as well as other professionals — ensure that each of our clients has a comprehensive, effective estate plan tailored to his or her particular needs and wishes.

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We welcome the opportunity to discuss your situation and provide the services required to help you achieve your estate planning goals. Please call us today and let us know how we can be of assistance.

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