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Utilizing Current High Gift Tax Exemptions Before 2026 (or Sooner)

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Since changes to the tax law remain unknown, it is worth considering making gifts while the increased exemptions exist and before gifting techniques become limited.

Wealthy families are transferring millions of dollars of asset value ahead of the looming reduction to the federal estate, gift and generation-skipping transfer tax exemptions (federal exemptions). The reasons are many—but begin with the passage of the Tax Cuts and Jobs Act of 2017 (TCJA). When the TCJA passed, the federal exemptions doubled, increasing the 2017 federal exemptions from $5,490,000 (the then $5,000,000 exemption, as indexed for inflation) to $11,180,000 in 2018. As of 2021, the federal estate and lifetime gift tax exemption is $11,700,000 per individual ($23,400,000 for a married couple, with portability). However, the TCJA will sunset on Dec. 31, 2025: on Jan. 1, 2026, the federal exemptions will reduce to $5,000,000, as indexed for inflation.

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New Administration, New Tax Laws

Along with the scheduled reductions to the federal exemptions, the 2020 federal election results are causing further concern about potential changes to the federal taxation of estates and gifts.

Since the election, there is no shortage of possible scenarios that could impact the current federal estate, gift and generation-skipping transfer tax regime. The scenarios include reducing the federal estate tax exemption to $3,500,000 and reducing the federal gift tax exemption to $1,000,000. Furthermore, there is talk about raising the rate of taxation on estates/gifts that exceed the exemption from the current 40% to a potential 65%, for estates/gifts exceeding $1,000,000,000.

The longstanding generation-skipping transfer tax exemption allows wealthy families to transfer wealth beyond their children, or to unrelated persons who are more than 37.5 years younger, without incurring a tax. However, it is not immune to change.

The “For The 99.5 Percent Act,” proposed by Bernie Sanders, provides that qualifying generation-skipping trusts must terminate 50 years after the trust is created. Currently, there is no such set termination.

Another potential change would limit the step-up in basis at death, while also making death a capital gain recognition event. Currently, the step-up in basis is available for certain transfers at death (to reduce capital gains accrued during the decedent’s lifetime). With regard to gifts, the donee receives the donor’s basis—known as carryover basis. If step-up in basis on death is reduced—gifting now becomes even more attractive.

What Should Be Done in Response to the Potential Tax Law Changes?

While there is no need to panic, now is the time to get your team together: your accountant, financial advisor and attorney. Review your assets and the ownership thereof and beneficiary designations thereon, if any, together with debt and income needs. It is also a good time to review current estate planning documents.

Begin with the foundation of the estate plan: the last will and testament and revocable trust (sometimes referred to as a living trust). These estate planning documents can include various tax savings provisions. Make sure that your last will and testament/trust properly express your intent.

Consider Gifting

After completing the basic estate planning documents, wealthy individuals and couples may wish to consider using their gift and generation-skipping transfer tax exemptions (currently $11,700,000 or $23,400,00 for married couples) to make gifts to children and grandchildren prior to tax law changes. Consideration should be

given to making these gifts in trust to protect the spouse, children and grandchildren. The terms of each trust will vary depending on the individual's goals. (Further discussion of trusts follows.)

To illustrate the benefit of gifting during the increased federal gift exemption: Assume that Harry and Wilma are married and that they make a gift of $23,400,000 now—instead of holding said assets until the death of the surviving spouse. By making the gift during the increased exemption period, Harry and Wilma remove $23,400,000 from their estates—gift and estate tax-free. Harry and Wilma also remove the appreciation on the amount gifted from their estates. If the gift is not made and the federal estate tax exemption is reduced to $3,500,000 per person ($7,000,000 per married couple), then on the second of Wilma and Harry's deaths their heirs will receive $6,560,000 (assuming a 40% estate tax rate) less than what they would have received had the gift been made ($23,400,000 – $7,000,000 exemption = $16,400,000*40% = $6,560,000 tax) prior to the reduction to the federal exemptions. That potential tax due does not factor in any increase to the rate of the estate tax, nor does it include any state estate/inheritance tax (yes, multiple states still have a state-level estate and/or inheritance tax).

Many taxpayers ask what effect making large gifts will have on their estate once the federal exemptions are reduced, including whether the government will clawback the additional exemption used. Clear guidance through IRS Treasury Decision 9884, states that no such clawback would occur. In short, the final regulations allow for the estate to use the greater of the credit for the exemption utilized for the gift that was made during the increased exemption period or the credit on the estate exemption amount available at death.

To demonstrate the practical effect of IRS Treasury Decision 9884: If an individual makes an $11,700,000 gift during 2021 (and no other gifts) and, as such, no federal gift and/or generation-skipping transfer tax is due and then dies after 2025 (with $0 assets) when the federal estate tax exemption is $3,500,000, no federal estate tax will be due, as the greater of the two credit amounts will be utilized—the credit on $11,700,000 and not the credit on $3,500,000.

If the same individual makes a $3,500,000 gift in 2021 when the federal gift tax exemption is $11,700,000 and then dies after 2025 when the federal estate tax exemption is $3,500,000, that person will have exhausted her available exemption. The remaining $8,200,000 in that individual's estate would be taxed at the then federal estate tax rate; assuming 40%, $3,280,000 of federal estate tax would result.

Gifting in Trust

While the power of gifting during the increased exemption period is attractive, many clients are hesitant to gift their money outright to their children. They fear that their children will misuse or lose the assets to creditors, or that the donor's spouse may not have enough assets to support his/her lifestyle. To assuage client concerns, gifting to a trust is a very popular option. Making a gift of the current federal gift tax-exempt amount to a spousal lifetime access trust (SLAT) is a popular option.

A SLAT can provide benefits to the donor's spouse while also taking advantage of the current federal gift tax exemption. For example: Assume Wilma creates and gifts assets to a SLAT. Depending on the terms of the SLAT, her spouse, Harry, will receive income and possibly principal. As such, while Harry is alive (and on good terms with Wilma), the standard of living of Harry and Wilma may continue unaffected. Upon the death of Harry, all amounts payable to Harry cease and the trust assets pass to the next (remainder) beneficiaries named in the trust document. Such remainder beneficiaries can receive the trust assets outright

or in further trust. Suppose the assets are held in trust for Wilma's children. In that case, they can receive income and principal during their lives, and the trust can continue for Wilma's grandchildren without being taxed in Wilma's children's respective estates. Wilma's generation-skipping transfer tax exemption would be allocated to the trust.

Another potential benefit of gifting assets to a lifetime trust for the benefit of a child is possible asset protection for the child, as the trust assets may not be reachable by the child's creditors, including the ex-spouse.

Married individuals wishing to both create SLATs (to utilize both gift tax exemptions—up to $23,400,000) must be careful in doing so to avoid the reciprocal trust doctrine, which would void the tax benefit and cause estate inclusion. To avoid the reciprocal trust doctrine, trust drafters should consider various differentiating factors, including having different: trustees, distribution standards, beneficiaries, trust creation dates and assets contributed to each trust.

While the gift and generation-skipping transfer tax exemption is currently $11,700,000, many advisors are concerned about their clients using their full exemption in 2021. This is because it is still unknown if the exemptions will be decreased before the end of 2021 and if such a reduction will be retroactive for all gifts made during 2021. Given the potential for retroactive legislation, instead of gifting a definite asset/amount, many estate planners suggest that the gift be tied to a value that will not exceed the donor's gift tax exemption. The successful Wandry case (Joanne M. Wandry et al. v. Commissioner) provides guidelines for using a formula clause to avoid the donor having an unexpected tax bill.

Benjamin Franklin said it well: "In this world, nothing can be said to be certain except death and taxes." To prepare for both such certainties, there are many gifting techniques that individuals can utilize. However, in addition to the potential tax changes above, there are proposals to limit the benefits of various gifting techniques, including GRATs and grantor trusts. So, since changes to the tax law remain unknown, it is worth considering making gifts while the increased exemptions exist and before gifting techniques become limited.

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