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New tax law bonus for some, but you must know the rules

Over the next five years we will see major changes in the estate tax climate. Under the Tax Cuts and Jobs Act, Congress doubled the amount which could be passed estate tax-free from $5 million, adjusted for inflation, to $10 million, adjusted for inflation. However, what many don't recognize is that this adjustment is not permanent.

Under the act, in 2026 the exemption will revert to the $5 million level, adjusted for inflation. And, depending on who wins the presidency and control of one or both legislative chambers, in 2020, we may see pressure by a new president and Congress to decrease the exemption even before 2026. This has many high-net-worth clients racing to use it or lose it.

The exemption

Based on the year in which you die, the federal government allows a portion of your estate to pass estate tax-free, commonly referred to as the "exemption amount." Individuals may also gift portions of their exemption amount during their lifetime, known as the gift exemption, a portion which can be considered generation-skipping transfer tax exempt.

For 2020, the current exemption is $11.58 million. For married couples with a properly structured estate plan, each spouse should be able to pass $11.58 million estate tax-free or $23.16 million for a married couple.

The exemption amount can be passed at death or an individual may gift the exemption amount during her lifetime. Thus, high-net-worth clients are eager to gift the $23.16 million before the exemption drops dramatically. And, by doing so, they are able to transfer not only the current value of the asset but also income and future appreciation estate tax-free.

Favorable Treasury regulations

When the act was initially passed, the U.S. Treasury was instructed to promulgate additional regulations to carry out the purposes of the act and to issue guidance with respect to differences between the exemption amount in effect at the time of a decedent's death and at the time of any gifts made by the decedent.

How would the "claw-back" be handled?

Imagine a client gifted the full $11 million of her lifetime exemption and dies in 2026 when the exemption is only $5 million. This initially created cause for concern because any lifetime gifts are included in the taxable gross estate for purposes of calculating the estate-tax liability.

If a client gifted $11 million of lifetime exemption this year and dies in 2026 with only $4 million, the value of the client's taxable gross estate would be $15 million with an exemption of only $5 million.

Therefore, the estate would owe federal estate tax at a rate of 40% on every dollar over $5 million, which is in excess of the $4 million in the estate.

In 2018, the Treasury released proposed regulations which helped mitigate concerns of claw-back and in November 2019 the final regulations were issued. Specifically, there would not be an estate tax on assets gifted when the exclusion covered the gift. The estate would only pay tax on the $4 million in assets. These final taxpayer-friendly regulations have sent advisory teams scurrying to:

- Identify assets which are expected to appreciate the fastest.
- Design the appropriate structure to leverage discounts for valuation purposes.
- Draft irrevocable trusts which provide increased asset protection and generation-skipping transfer tax exempt benefits which reflect the client's personal goals.
- Use the $23.16 million exemption before you lose it.

The estate planning for each client is customized as each family has its own dynamics and goals on every aspect from who the beneficiary of the gift should be to what level of accessibility and control they should be granted.

While the terms of the documents may vary, proper planning should include gifts to irrevocable trusts.

Irrevocable trusts

The benefits of gifting to irrevocable trusts include:

- Asset protection from beneficiary's creditors.

THE BUZZ

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LINDSEY PAIGE MARKUS, *a shareholder at Chuhak & Tecson P.C., draws on her early career in business, finance and clinically applied neuroscience to communicate with clients and develop creative solutions to fit their estate planning, wealth protection and corporate needs. Lindsey is a dynamic contributor to local news outlets, and has been recognized one of the 40 Under Forty.*

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• More likely to maintain status of individual, nonmarital property.

• Assets are excluded from the beneficiary's estate (for special needs considerations, financial aid and the ability to maximize wealth transfer).

By gifting assets in trust they can be asset-protected from the beneficiary's creditors, including a future ex-spouse. While assets gifted during a marriage are still considered individual or nonmarital assets, if the recipient commingles the assets with marital funds or routinely uses the funds to benefit the marriage, the assets can quickly become tainted or transmuted to marital property. Assets that are gifted outright to a beneficiary are also included in the beneficiary's estate.

This may pose issues if the beneficiary is later diagnosed with medical issues, has special needs considerations or if the beneficiary is struggling financially and wishes to apply for financial aid.

In instances where the beneficiary has assets of her own or is expected to inherit more, by gifting assets in trust the assets can be structured so they are excluded from the beneficiary's taxable gross estate and that the maximum amount can pass estate tax-free from generation to generation.

Intentionally defective feature opens door for more tax planning

Clients are also encouraged to consider making the irrevocable trusts "intentionally defective." This feature makes the trusts defective for income tax purposes whereby the grantor is treated as the owner of the trust property for income tax purposes and all the tax attributes flow back to the grantor.

In this way, a future income tax liability paid by the grantor is not considered an additional gift. Ideally, the grantor will have sufficient cash flow to cover the tax liability. However, the trust can also have language to provide that the trustee may make a distribution of trust assets to the grantor to cover the tax liability.

Another benefit of the intentionally defective grantor trust is the flexibility it provides for planning. Specifically, if the gifted asset appreciates dramatically, the meticulous estate tax planning can come at a price in the form of income taxes. If the assets are sold after the grantor's death, the trust (or individual beneficiaries) would be subject to income tax on the sale.

Where a client gifts appreciated assets to an intentionally defective grantor trust, she can later purchase them back with cash or high-basis assets. By holding the appreciated assets in her name at the time of death, we are able to get a step-up in basis to fair market value, thus avoiding 23.8% of income taxes.

Children's trusts, grandchildren's trusts and spousal limited lifetime access trusts

For many, gifting to trusts for the benefit of children and grandchildren takes priority and can easily be established for the benefit of a child or grandchild or multiple children or grandchildren.

For countless other clients, regardless of their high-net worth and no matter what the Monte Carlo simulation analysis identifies regarding the degree of certainty that there are more than sufficient funds to provide for their lifestyle, clients never want to be in a position where they have to ask a child or grandchild for money.

In these situations, a spousal limited lifetime access trust, or SLAT, has proven to be a wonderful planning tool. A SLAT is an irrevocable trust for the benefit of a spouse (or spouse and descendants) during the spouse's lifetime.

By gifting through the SLAT, we are able to move the assets outside of both spouse's taxable gross estates. Ideally, the spouse does not need the assets and the funds can grow estate tax-free for the next generation, but if a financial reversal occurs, there are assets available for the spouse.

SLATs have given countless families greater peace of mind to move forward when making larger lifetime gifts.

In summary, $23.16 million is a lot to leave on the table. While the idea of parting with that amount of wealth may create some hesitation, there are countless ways the planning can be customized to suit your particular goals. Use it before you lose it.

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