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PREPARING FOR POSSIBLE ESTATE TAX LAW CHANGES

Unless the current estate tax laws are changed by future politicians, the existing gift and estate tax exemption laws will expire on December 31, 2025. And while that date may sound quite distant, now is the time to begin preparing for these anticipated changes.

The current gift and estate tax exemption is set at $13.6 million per individual. This means that either during life or at death, an individual may gift to his or her beneficiaries up to this amount without incurring a gift or estate tax. For a married couple, this amount is doubled, allowing them to give up to $27.2 million tax free, during life or at transfer upon death. It's important to be aware that a spouse or charity is not considered a beneficiary. The good news, however, is that when giving to either a spouse or charity, there is no limit on the amount you may gift.

When the current exemption expires, it will likely be reduced from $13.6 million to $7 million per person. Therefore, the exemption total for a married couple would also reduce to be $14 million rather than $27.2 million.

The question that must be answered by this anticipated change is, *"Does it make sense for me to take advantage of the current exemption ($13.6 million/individual; $27.2 million/couple) prior to the law changing at the end of 2025?"* Arriving at an initial, educated answer to this question is fairly easy, but should your answer be "yes", your subsequent decisions then become more complex. The rest of this article will highlight the various gift/exemption options available, some of their advantages and disadvantages, and provide general counsel on what should be considered in your decisions.

To begin, taking advantage of the current exemption only makes sense if you are likely to have a taxable estate after the exemption is reduced. In other words, if you are an individual with an estate of $7 million or less, or a couple with an estate of $14 million or less, it is probably not something about which you should worry. However, if your estate exceeds those amounts, then acting before the end of 2025 is a worthwhile consideration.

Taking advantage of the higher exemption involves making an *irrevocable* lifetime gift of as much of the exemption as you can afford. When deciding the amount of this gift, it is critical to ensure that you retain sufficient assets to continue to support yourself during your lifetime. Please also be aware that except for a Spousal Lifetime Access Trust (discussed further below), you cannot be a beneficiary of the gifted assets.

Just because your estate may be over $14 million, however, doesn't automatically mean it's best to make a lifetime gift now. It may not make sense if you are only able to give a portion of the exemption. This is because any gift that is only a portion of the full exemption comes off the "bottom" of the exemption rather than off the "top". For example, assume your estate is $15 million. You determine you can comfortably continue to support yourself on $9 million and thus, choose to make a lifetime gift of $6 million. Once the gift is made, a Federal Gift Tax Return (Form 709) is filed, reporting the $6 million gift and applying it against your $13.6 million exemption. However, if the exemption is thereafter reduced to $7 million and you have already gifted $6 million, your remaining exemption is now only $1 million. In summary, the advantage of making a lifetime gift against the higher exemption only exists if you can gift close to the entire $13.6 million.

Once you determine it may be advantageous for you to make a lifetime gift, there are also other details to carefully contemplate. The first detail pertains to capital gains tax rather than estate tax, and how the timing of any appreciated asset gift, determines that asset's eligibility for a "stepped-up" basis upon death. To illustrate, let's consider a home, which you purchased for $500,000, and is now worth $3 million. If you were to sell your home during your lifetime, you would incur a capital gain of $2.5 million and be taxed on that capital gain accordingly. Similarly, if you were to gift the home to your heirs during your lifetime, they would also incur capital gains tax. This is because a lifetime gift of an asset is *not eligible* for a stepped-up basis. However, if your heirs inherited the home upon your death, it would then be received with a stepped-up basis of $3 million and they would be able to sell the home *without* incurring any capital gains tax. This example applies to any appreciated asset, whether real estate, marketable securities or other investment assets.

In this example of a lifetime gift, the benefit of removing the gifted asset from your estate for estate tax purposes, would be diminished by foregoing the stepped-up basis on the asset when you die. Such a "gift" would also potentially place a burden on your heirs, who would have to pay the capital gains tax based on your original cost basis when they choose to sell the asset. Thus, you are trading off eliminating the estate tax against your heirs incurring the capital gains tax upon sale. This may be a good trade off if your heirs do not intend to sell the asset or if capital gains taxes are lower than estate taxes or if the capital gains taxes can be deferred as is the case with a 1031 exchange or a Delaware Statutory Trust if real estate is involved.

If you are a married couple, another option available to take advantage of the higher exemption, while addressing the issue of access to the gifted assets, is a Spousal Lifetime Access Trust (SLAT). A SLAT involves the husband setting up an irrevocable trust with the wife as the lifetime beneficiary and the children and grandchildren as remainder beneficiaries. The husband would then gift up to $13.6 million into the wife's SLAT, giving the wife access to those assets during her lifetime. Conversely, the wife could then also create a SLAT for the husband's lifetime benefit with the children and grandchildren as remainder beneficiaries. The wife would then gift up to

$13.6 million into the husband's SLAT, giving the husband lifetime use of the assets. Of importance to note, however, if that when the named lifetime beneficiary of either SLAT dies, the remaining spouse no longer has access to the assets in their spouse's SLAT.

In structuring SLATs, caution must also be given to avoid the "Reciprocal Trust Doctrine". The Reciprocal Trust Doctrine allows the IRS to disregard the SLATs if it is determined that they are substantially identical trusts; one for the benefit of the husband and one for the benefit of the wife. Therefore, care must be taken in the design and implementation of the SLATs. This can be accomplished by ensuring the SLATs have slightly different terms, are preferably executed on different dates, and funded with different assets.

Should you wish to consider making a lifetime gift of California real property, it is critical to also pay careful attention to the rules under Proposition 13 that trigger a reassessment of the property taxes. These rules are complicated, and you will want to avoid any of the gifting that causes premature property tax reassessment. There are strategies that may be employed to avoid the property tax reassessment, but they involve careful planning and implementation.

Lastly, if you are in the fortunate position of having an estate well in excess of either the current $13.6 or $27.2 million exemption, an additional option may be possible outside of only making lifetime gifts. This option is to sell assets to an irrevocable trust in exchange for a promissory note. This is particularly advantageous if you own real property, and you transfer a fractional interest in an entity (LLC or partnership) that owns the real property. In such a scenario, the value of the transfer is discounted based on lack of control and lack of marketability. Typically, those discounts will be 30 - 35%. When your fractional interest is sold at the discounted value, you then take back a promissory note for the purchase price. Advantages of this include:

1. Removing the real property from your estate at a discounted value, thereby removing any appreciation in the real property from your estate; and
2. Replacing the real property, which is likely to be an appreciating asset, with a promissory note, which is a fixed asset. This accomplishes what is commonly referred to as an estate freeze.

As you can see, the issues around making lifetime gifts against your available gift and estate tax exemptions are complicated, and the best course of action will vary client to client. If you would like to further discuss and understand the options as they apply to your situation, feel free to contact me and we can schedule a time to discuss it.