October 15, 2020

Estate Planning Techniques to Consider in Anticipation of Potential Changes to Estate and Gift Tax Law

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The upcoming election has caused many taxpayers to be concerned regarding potential changes to the estate and gift tax law. Currently, the federal gift and estate tax exemption is $11.58 million per person. This is the highest the exemption has ever been. Pursuant to the terms of the Trump Administration's tax law, which was passed in 2017, the exemption is scheduled to revert back to $5 million, adjusted for inflation, on January 1, 2026. The estate and gift tax rate are a flat 40% on the value of an estate in excess of the exemption.

The concern is over the uncertainty to the answers to the following questions: (1) Will the $11.58 million transfer tax exemption remain in effect if Mr. Biden wins the election and/or the Democrats win control of the Senate? (2) If the $11.58 million exemption is not made permanent, could the exemption go even lower than $5 million? (3) How soon could a lower transfer tax exemption go into effect?

Presidential candidate Joe Biden has proposed reducing the exemption significantly. Granted, even if Mr. Biden wins the election, his proposal will not become law unless it approved by Congress. But if that happens, it is possible that a lowered exemption could be made retroactive, and go into effect as early as January 1, 2021.

Taxpayers who are worried about the estate tax have some estate planning options that can reduce their tax burden.

Among those options are:

Creation of a Spousal Lifetime Access Trust (SLAT). A SLAT is an irrevocable trust created by one spouse for the benefit of the other. The purpose of the SLAT is to use up some or all of your $11.58 exemption before it is taken away. A SLAT is designed to allow your spouse to receive distributions from the trust, while at the same time, the assets of the trust (and the appreciation thereon) are excluded from both the estate of the gifting spouse and the beneficiary spouse. At the beneficiary spouse's death (regardless of whether the donor spouse is still alive), the SLAT assets pass to the remainder beneficiaries (usually their children).

Creation and Funding of Irrevocable Trusts for Non-Spouse Beneficiaries. This is like a SLAT except your spouse is not a beneficiary of the trust. Taxpayers who would like to pass assets to non-spouse beneficiaries may create irrevocable trusts to hold assets for other beneficiaries, and contribute any amount up to his or her current lifetime estate and gift tax exemption amount to the trust without incurring any gift tax. The contributions to the trust would then pass to the beneficiaries free of estate or gift tax. The taxpayer can dictate the terms under which assets may be distributed, can designate a trustee to manage and control the distribution of the assets. A taxpayer who creates an irrevocable trust can even pay all of the taxes owed on income generated within the trust, which is a great result because it allows the trust to grow tax free during the taxpayer's lifetime.

Gifts to Family Members of an Interest in an Entity. A taxpayer who has created an entity (for example, a limited liability company) and transferred assets to the entity may gift a portion of the entity to his/her children (either outright or to a trust), may be entitled to a discount on the value of the gift for gift tax purposes. A discount may be available because the recipient of the minority interest has no control over the management of the entity.

Outright Gifts to Beneficiaries. A taxpayer may also gift assets to beneficiaries outright, thus removing the assets from his or her taxable estate. Currently, each calendar year you can give as much $15,000 to as many individuals as you wish, tax free, without using any of your lifetime gift and estate tax exemption, or $30,000 if your spouse agrees to "split gift" treatment of the funds. Gifts up to the amount of your lifetime exemption can also be made tax-free, but must be reported on a federal gift tax return.

Creation of a Grantor Retained Annuity Trust (GRAT). A GRAT is a vehicle for a beneficiary to receive the appreciation on an asset free of transfer tax consequences. The individual who creates the trust – the grantor – funds it with assets that the individual anticipates will increase in value over the GRAT term. The grantor retains a stream of annuity payments for a specific term of years, usually no shorter than 2 years and no longer than 5 years. The value of the retained stream of payments is typically about equal to the value of the assets funding the GRAT. At the end of the GRAT term, any assets remaining in the GRAT (that may consist of accumulated income or appreciation) are distributed to the trust remainder beneficiaries. The GRAT technique works if the following two requirements are met: (1) the grantor must survive the term of the GRAT; and (2) the assets in the GRAT must appreciate at a greater than the applicable federal interest rate. This is a useful planning tool for assets that are expected to appreciate significantly during the GRAT term. GRATs are a potential solution for individuals who wish to transfer wealth but not use up any of their exemption.

Installment Sale to an Intentionally Defective Grantor Trust. This technique is a method to freeze the value of assets includible in a taxpayer's gross estate, and to allow the beneficiary to inherit tax-free the increase in value of the assets between the date of transfer and the date of the taxpayer's death. This technique involves both a gift and a sale to a trust. Under this technique, the grantor sells assets (such as closely held business interests) to a trust in exchange for an installment note. In addition, a gift typically in the amount no less than 10 percent of the assets to be purchased, usually referred to as a "seed gift," is made to the trust. The purpose of the gift is there is sufficient cash to make the loan payments to the grantor. The trust is structured so that there is no capital gains tax consequences resulting from the sale. In addition, during the grantor's life, the interest payments on the installment note will not be deemed taxable income to the grantor, and the payment of taxes on the trust's income provides an additional gift-tax-free benefit to the beneficiaries.

Other options are available for taxpayers who are charitably inclined.

Taxpayers who are concerned about the effect of any changes in tax law should consult with their estate planning attorney to learn about the options available to them, and to determine which of the options described above are most appropriate for that taxpayer's circumstances. Many of these solutions require extensive time to create the appropriate documentation and to make the necessary transfers; therefore, it is advisable to contact an attorney as soon as possible to determine the best course of action.

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