Client Alert

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Estate Planning in Anticipation of the Impending Rollback of Increased Estate and Gift Tax Exemption

In 2017, Congress enacted major tax legislation known as the Tax Cuts and Jobs Act of 2017 ("TCJA") which, among other things, doubled the estate and gift tax exemption. For the TCJA to meet Congressional cost requirements, this increase in exemptions could only last for a limited period of time before reverting back to the pre-TCJA levels on January 1, 2026, as indexed for inflation.

While this deadline is still several months away, taxpayers should plan ahead to decide whether to take advantage of this "bonus" or double exemption. Regulations issued by the U.S. Treasury in 2019 assured taxpayers that the government could not claw back the bonus exemption amount that may have been used by taxpayers prior to January 1, 2026. Thus, the opportunity to employ strategies to use the additional exemption amounts remains viable under the right circumstances.

This article will review the exemption amounts under the TCJA insofar as it provides estate planning opportunities, as well as provide an overview of other strategies to consider.

<u>Basic Exclusion Amount Under the Internal Revenue Code</u>

The Internal Revenue Code sets forth the amount that taxpayers may transfer during their lifetime or at death without incurring federal gift or estate tax liabilities. This threshold is referred to as the Basic Exclusion Amount ("BEA"). Lifetime gifts to non-spouse individuals reduce a taxpayer's available BEA, while any remaining BEA at death can shield all or part of the taxpayer's remaining assets from estate taxes. Transfers exceeding the BEA are subject to gift or estate taxes, with rates that currently range from 18% to 40%. Tax laws also provide for an annual gift tax exclusion of $18,000 per donee, which is the amount taxpayers may exclude from the calculation of their taxable gifts each year per donee. Under the TCJA, the BEA doubled from $5 million to $10 million (or $10 million to $20 million for married couples) for the years 2018 through

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2025. As of 2024, the BEA stands at $13.61 million for individuals and $27.22 million for married couples, as adjusted for inflation.

In addition to the federal gift and estate tax, the tax laws also impose a generation-skipping transfer tax ("GST Tax") on transfers of property that skip a generation, designed to prevent taxpayers from avoiding estate taxes by transferring assets directly to individuals who are a generation below their children—typically their grandchildren or great-grandchildren. Like the exemption for gift and estate taxes, a similar exemption equal to the amount of the BEA is allowed for GST Tax purposes. This exemption was also increased for the years 2018 through 2025 under the TCJA.

Planning for the End of Increased BEA

In 2019, the U.S. Treasury issued Treasury Decision 9884, clarifying that the increased BEA applies to taxpayers making gifts between 2018 and 2025. It allows taxpayers to choose the higher of two BEA values: the BEA at the time of the gift or the BEA at the taxpayer's death.

Determining whether gifting today is beneficial requires careful consideration of broader financial objectives. For instance, younger individuals and couples should consider whether current gifting may deplete their assets. Similarly, those in retirement who anticipate a longer lifespan must strike a balance between strategic gifting and securing sufficient resources to sustain their lifestyles throughout retirement. Notably, for current gifting to be advantageous, the gifted amounts should exceed the anticipated reduced BEA of $5 million, as indexed for inflation. Therefore, taxpayers should consider gifting up to the currently allowable BEA amount before the increased threshold expires. For example, if a gift of the BEA is made before 2026 in the amount of $13 million, none of such gift will be subject to gift or estate tax. But if the gift is not made before the BEA is only an estimated $6 million when the donor dies, $7 million of the $13 million gift will be subject to estate tax. For New York residents, an additional benefit of gifting is that New York has no gift tax and gifts are not subject to New York estate tax if made more than three years before the descendant's death.

Using a trust is particularly helpful for taxpayers who wish to provide for their surviving spouses during their lifetime while retaining control over the ultimate disposition of property after the surviving spouse's death. This is also helpful for taxpayers in a second marriage who wish to ensure that children from the first marriage receive the property following the surviving spouse's death. If, however, the beneficiary spouse dies prematurely or divorces the grantor, the grantor will lose access to the trust assets. Thus, it is important that the trust agreement specifically defines "spouse" to mean the beneficiary spouse while he or she is married to the grantor, or if the grantor remarries, to mean the new spouse.

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Since transfers to spouses are protected from estate or gift taxes by the unlimited marital deduction, the BEA can be used for transfers to beneficiaries other than a surviving spouse. For instance, taxpayers can make gifts to a Credit Shelter Trust ("CST"), also known as a "by-pass" trust or Spousal Lifetime Access Trust ("SLAT"), which ensures that the transferred amount goes to their beneficiaries free of estate or gift taxes. The CST or SLAT can be structured to provide payments of income and, if desired, principal to the surviving spouse, as well as discretionary distributions to the children or other beneficiaries. Alternatively, the CST or SLAT can be designed so that the surviving spouse only receives income during his or her lifetime, and the remaining assets pass to the children or other beneficiaries upon the surviving spouse's death.

Other estate planning alternatives include the use of Dynasty Trusts, which are designed to last for many years and facilitate tax-free transfers of wealth. Dynasty Trusts are established for the benefit of a taxpayer's descendants, often grandchildren or more distant descendants, and may be funded up to the amount of the BEA and/or GST Tax exclusion amount. With Dynasty Trusts, assets are removed from the taxpayer's estate for estate tax purposes, and successive generations may receive their inheritance without being subject to estate taxes. While Dynasty Trusts are not available under New York laws due to the state's Rule Against Perpetuities—which prevents people from controlling the disposition of assets after their death indefinitely—they are permitted in other states, such as Alaska, Delaware, New Jersey, and South Dakota.

Another planning opportunity is to transfer property into a Grantor Retained Annuity Trust (a "GRAT"). With a GRAT, the taxpayer can make a gift to the trust and receive a fixed income payment annually for a number of years. Any property that remains in the GRAT after the term of the fixed income payments can be distributed to the beneficiaries, such as children or other members of the family. For gift tax purposes, the value of the gift is calculated by subtracting the fixed payments from the total value of the property transferred to the GRAT. This calculation reduces the value of the gift, even to zero, while the appreciation in value of the gifted assets can go to the beneficiaries free of estate and gift tax.

Taxpayers may also consider making charitable gifts while leveraging the increased BEA. One approach is to establish a Charitable Lead Trust ("CLT") or a Charitable Remainder Trust ("CRT"). As their names suggest, both are estate planning strategies that allow taxpayers to support charitable causes while receiving tax benefits, providing income and transferring property to beneficiaries. In a CLT, the taxpayer transfers assets to the trust, which then makes payments of income to one or more charities for a set term—this could be a number of years or based on the lifetime(s) of certain individuals. After the term ends, any assets remaining in the CLT are distributed to non-charitable beneficiaries, usually family

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members. On the other hand, in a CRT, income is first paid to non-charitable beneficiaries for a set term, with the remaining assets distributed to designated charities upon termination of the trust. The income disbursed can be a fixed annuity payment (in a Charitable Remainder Annuity Trust or CRAT) or a percentage of the trust's assets (in a Charitable Remainder Unitrust or CRUT). Both CLTs and CRTs offer significant tax benefits. With a CLT, the taxpayer receives an upfront charitable income tax deduction for the present value of the income going to charity. Similarly, with a CRT, the taxpayer receives an upfront charitable income tax deduction for the value of the remainder interest going to charity. Assets placed into a CLT or CRT are removed from the taxpayer's estate for estate tax purposes.

Lastly, the use of an Irrevocable Life Insurance Trust ("ILIT") may provide another strategy for taxpayers to consider in their estate planning. An ILIT is designed to own life insurance policies on the life of the insured taxpayer and manage the policy distributions upon his or her death. Using an ILIT removes the policy proceeds from the taxpayer's estate. Certain formalities must be observed to ensure the exclusion from the insured's estate. If the gifts are made to fund the policy premiums before 2026, taxpayers can take advantage of the increased BEA. Additionally, ILITs may be structured to allow for Crummey powers, which allow beneficiaries to withdraw a portion of the trust assets for a limited period, thereby qualifying the contributions for the annual gift tax exclusion.

Conclusion

As the sunset of the increased BEA approaches, there are important opportunities available for strategic estate planning. The reduction of the BEA to previous levels in 2026 will impose a significant limitation for taxpayers to shield their assets from gift and estate tax. Moreover, it is worth noting that certain states, such as New York, impose a separate state estate tax regime with lower exemption amounts than the federal BEA.

With the window of opportunity closing and given the time-consuming nature of estate planning, taxpayers should consider seeking guidance from their estate planning advisors. Doing so will enable them to capitalize on the current estate planning opportunities that are available to them.

Please contact the Olshan attorney with whom you regularly work or the attorneys listed herein if you would like to discuss further or have questions.

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