US Private Wealth Management
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New tax law clarification on giving

Insights

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The Tax Cut and Jobs Act of 2017 created what appeared to be an expanded opportunity for tax savings through strategic use of gifting strategies. The new tax law doubled the unified gift and estate tax exemption from approximately $5 million per person to more than $10 million per person. This clearly makes it possible to settle large estates with a reduced estate tax liability for those who die between 2018 and 2025. However, the fact that the exemption would revert to previous law, essentially cutting the amount exempt from tax in half, again in 2026, was a limiting factor as it related to lifetime gifting.

Since the law took effect on January 1, 2018, there has been a significant unanswered question – what would be the tax treatment of an individual's estate who made lifetime gifts that were exempted under the temporary expanded exemption period if the individual died after the law expired in 2025? The U.S. Treasury Department examined the issue and recently released an interpretation of the tax law. This ruling is clearly favorable to families seeking to take full advantage of the recent tax law change for purposes of gifting during their lifetimes.

The changing state of gift and estate tax laws

There have been frequent changes to the gift and estate tax law over the years. In recent times, the amount exempted from taxes was as low as $650,000. There was a one-year period where individuals could fully avoid the estate tax.

This table outlines the frequency of changes in the exemption amount in recent years and projected into the future as well:

Changing estate tax exemptions

Year of death	Unified exemption amount
1999	$ 650,000
2000-2001	$ 675,000
2002-2003	$1,000,000
2004-2005	$1,500,000
2006-2008	$2,000,000
2009	$3,500,000
2010*	$5,000,000
2011-2017**	$5,000,000
2018-2025**	$10,000,000
2026***	$5,000,000

See footnotes on page 2

* Estates of decedents dying in 2010 were given a choice between incurring no estate tax but limiting the basis increase on inherited assets, or using a $5 million exclusion with traditional "step up in basis" rules. There was only a $1 million gift tax exclusion in 2010 but from 2011 onward it is similar to the estate/GST tax exclusion.

** $5,000,000 and $10,000,000 were the base levels of the unified exemption amount. Since these amounts are subject to annual inflation adjustment, the actual exemption amount is higher. In 2017, the exemption was $5,490,000. In 2018, the exemption was $11,180,000. In 2019, the exemption amount is $11,400,000.

*** Reverts to previous law. Exemption amount listed is likely to actually be an amount close to $6,000,000.

As this table makes clear, the unified gift and estate tax exemption has been a moving target over the years. Even the changes included in the 2017 tax law could be subject to change before they expire in 2025. It is also possible that Congress will vote to extend this expanded exemption amount beyond 2025. What is relevant today, however, is that an unprecedented tax saving opportunity exists today with the $11,000,000+ individual exemption amount.

The key issue with the current exemption amount

While there is little question of how the expanded exemption impacts estates for those who die between now and 2025, the more pertinent question is what happens in cases where significant gifting occurs between now and 2025, but the grantor dies in 2026 or later, when, as the law now stands, a lower exemption amount will once again apply.

Individuals, families and tax advisors have sought clarification on the rules. In November, 2018, the Treasury Department provided that clarification. Pending a public comment period, the new regulations are expected to be in force in early 2019.

Note that because of the frequent changes in exemption limits and due to inflation adjustments, the numbers related to this discussion can be confusing. To simplify the explanation here, it will reference the base exemption amounts of $5,000,000 that applied prior to the 2017 tax law change, and $10,000,000 that applied after the change in the tax law. In reality, the actual exemption amounts are higher than that, but change from year-to-year.

As it concerns those who make substantial gifts between now and 2025, but die (resulting in the settlement of the estate) sometime after 2025, the issue is potential future estate taxation. This is the **worst-case scenario** that some were concerned may have applied prior to the recent Treasury Department ruling:

John is single and has an estate worth $10 million. Between now and 2025, John decides to gift $9 million to children and others. (For purposes of this example, we assume the expanded unified gift and estate tax exemption is $10 million.) Under the revised exemption amount, none of John's gifts would be subject to gift tax. After he completes his gifting, it leaves John with an estate valued at $1,000,000. Upon his death in 2026, the estate tax exemption has now reverted to the previous level of $5 million. If that were recognized as the applicable gift and estate tax exemption, it would mean that the first $5 million gifted by John would have exhausted his unified gift and estate tax exemption. $4 million of John's previous gifts plus the current estate value of $1 million would be subject to estate tax. At a 40% estate tax rate, John's estate would owe approximately $2,000,000 in federal estate taxes. In effect, this imposed an estate tax on a portion of the gifts that were sheltered under the applicable gift and estate tax exemption between 2018 and 2025.

In this circumstance, John would be discouraged from taking full advantage of the expanded unified gift and estate tax exemption of $10 million. He would want to retain at least a sufficient amount of assets in his estate to satisfy any future estate tax obligations. The good news is that the Treasury Department ruling has eliminated this scenario from consideration.

The new ruling encourages current gifting

The new ruling from the IRS provides a different interpretation. Here is an example of how the IRS will **actually** address estate valuation and tax liability for those who die after 2025:

John takes advantage of the expanded gift and estate tax exemption, making gifts of $9 million between 2018 and 2025. This leaves his estate with $1 million. John *dies in 2026. Under the newly-proposed regulations, estate tax in this circumstance is determined based on the greater of:*

- *the year of death lifetime estate/gift exemption ($5 million applicable in 2026); or*
- *the amount of the prior gift tax exclusion used ($9 million at the time the gifts were made between 2018 and 2025).*

In this event, John's net taxable estate is only $1 million, generating only a $400,000 estate tax rather than $2,000,000. During the period of gifting, John does not have to be concerned that he might be liable for a net taxable estate of $5 million subject to an estate tax of $2 million (see previous example), even though the unified gift and estate tax exemption would have dropped to $5 million in 2026, when he dies.

Since the IRS will treat the gifts made between 2018 and 2025 in a more favorable manner, the gifting strategy dramatically reduced John's estate tax liability. Had John held the entire $10 million when he died in 2026, then $5 million of the estate would have been subject to estate tax (based on the non-inflation adjusted exemption amount). This could have resulted in approximately $2 million in estate taxes. This example demonstrates an obvious advantage of capitalizing on the present rules by making large gifts to reduce potential future estate tax liability.

Gifting also tempers growth within an estate

Because the future is unknowable and it is possible that a person with $10 million or more in assets may die on or before 2025, there would be, in this instance, no tax savings realized by gifting assets early. However, there are reasons to look at this opportunity differently.

Most notably, over the course of several years and perhaps longer, wealth has the potential to grow in value. Depending on the circumstances, it is possible that an estate currently valued at a level close to the full exemption amount will increase in value to a level that exceeds the exemption amount. If so, some portion of that growth would be subject to the estate tax.

By contrast, if a portion of the money is gifted to individuals or others, the assets are removed from the estate and any future growth of those assets would occur outside of the estate, limiting the estate's tax exposure.

The bottom line – a window is open to pursue major tax savings

The expanded unified gift and estate tax exemption applicable from 2018 to 2025 creates far more flexibility for those with significant assets to manage estates and seek ways to limit future estate tax liability. The recent rule clarification by the Treasury Department makes it clear that gifts made up to the expanded unified gift and estate tax exemption amount prior to 2026 will be exempted from tax. This is true even if the death of the benefactor doesn't occur until 2026 or later when the estate tax exemption amount is projected to be lower.

Please note that the dollar amounts used in the examples above do not reflect inflation adjustments. With inflation adjustments accounted for, the individual unified gift and estate tax exemption for 2019 is $11.4 million. For couples, that makes the combined exemption amount $22.8 million, a significant sum that can be protected from gift and estate taxes if properly managed.

Another important tax strategy for gifting remains unchanged. The annual exclusion amount for gifts from one individual to another is $15,000 in 2019. This means individuals can gift up to $15,000 per year to an unlimited number of beneficiaries without exhausting any of their unified gift and estate tax exemption.

Other strategies to consider in retaining control over assets

In some cases, individuals hesitate to initiate gifting strategies, preferring to retain control of assets until their deaths. By failing to take advantage of the current favorable gift tax exemption, they may sacrifice an opportunity to reduce future estate tax liability. There are a number of techniques that create the potential to take full advantage of the expanded gift and estate tax exemption while still retaining some control over the gifted assets. Here are several strategies to consider. Be sure to consult with financial, tax and legal advisors before you decide if any of these approaches are appropriate for you.

Spousal Lifetime Access Trusts (SLATs)
An irrevocable trust created by one spouse to benefit the other spouse and typically, additional family members such as children or grandchildren. The donor spouse gifts assets into the trust (utilizing the gift tax exemption) and no longer has access to those assets. The beneficiary spouse, however, maintains access to the property. Income from the trust continues to be reported on the grantor's tax return.

Spousal Lifetime Access Non-Grantor Trusts (SLANTs)
Similar to a SLAT, except the trust itself is treated as a taxable entity. The trust claims tax liability related to any income, deductions or credits, and a separate tax return is filed on behalf of the trust.

Domestic Asset Protection Trust (DAPT)
An irrevocable trust where the grantor gifts assets to the trust but is designated as a permissible beneficiary and allowed access to funds in the trust account. This is a way to protect assets from potential future creditors and provide potential tax savings.

Hybrid Domestic Asset Protection Trust
In this form, the Trust Protector can add the grantor or remove the grantor as a permissible beneficiary.

Irrevocable Grantor Trust (IGT)
This form of trust is very similar to a SLAT but would not name a spouse as beneficiary. Somewhat similar to a "hybrid" trust, it may grant beneficiaries or other parties a lifetime limited power to appoint assets to others, including to the grantor.

Married couples maximizing their exemptions

One key to fully exploiting the current favorable exemption status is for married couples to be sure to take full advantage of the opportunity. In 2019, each individual is eligible to make tax-exempt gifts up to an $11.4 million lifetime limit. It is likely that this exemption amount will increase through 2025 due to inflation adjustments, likely topping out to a lifetime limit of approximately $12 million per person. For couples who are comfortable gifting the maximum allowed, it is wise to make full use of the expanded unified gift and estate tax exemption that is currently available.

Between 2019 and 2025, a married couple will have the ability to gift more than $22 million with no gift tax due. It will reduce their taxable estate. If they die after 2025 and assuming the unified gift and estate tax exemption is cut in half at that time, they will have leveraged the unique opportunity to gift during the series of years where the expanded exemption amount applied.

For couples that may only be comfortable making partial use of the current expanded gift tax exclusion, it may be advantageous to not split gifts. Consider making all significant gifts in the name of one spouse only (be aware that special care should be taken in community property states). For example, if both spouses made gifts of $5.5 million dollars between 2018 and 2025, then passed away after 2025 when the estate tax exemption reverts to $5 million, they achieved no tax benefit. If, instead, one spouse makes the entire $11 million gift, he or she may take full advantage of the expanded exemption allowed between 2018 and 2025. This strategy could significantly reduce the family's estate tax liability.

There is a unique opportunity today to more effectively manage estates and avoid estate tax liability. Of course, as is always the case, all gifting should occur within the context of a broader financial plan. Be sure financial, tax and legal advisors are consulted before making any decisions.

