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Jennifer Davis

Garrett Reuter, Jr.

Keith Grissom

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Use it or Lose it:
Big Changes Coming for the Federal Estate and Gift Tax Exemption

Keith K. Grissom

Greensfelder, Hemker & Gale, P.C.

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Unified Lifetime Gift and Estate Tax Exemption

- Under current law, in 2023 individuals are able to give away during life, or pass along to others at death, up to $12.92 million in assets, or $25.84 million in assets for a married couple, without causing any gift or estate taxes.
- This lifetime exemption from gift and estate taxes, technically referred to as the "basic exclusion amount," is unified, meaning that gifts made during life that reduce the lifetime gift tax exemption will also reduce the individual's estate tax exemption at death.
- Any amount given away during life or passed to another at death in excess of this amount will be taxed at rates of up to 40 percent.

Annual Exclusion Gifts

- There are, however, ways to make gifts without using lifetime exemption.
- In 2023, each individual may gift up to $17,000 per calendar year to any number of individuals or qualifying trusts without incurring a gift tax. This is called the annual exclusion. Married couples can currently gift up to $34,000 per donee gift tax-free.
- Like the lifetime exemption, the annual exclusion is indexed for inflation, with an expected increase next year to $18,000 per donee.
- In addition, payments made to cover tuition or medical care expenses for someone can be made without using the lifetime exemption or annual exclusion.

Annual Exclusion Examples

- **Suppose a grandmother decides to gift $17,000 to her granddaughter in 2023 for her granddaughter to use however she wants.**
- There are no gift tax consequences to this transfer.
- **What if instead the grandmother gives the granddaughter $20,000 in 2023 for use however she wants?**
- In that case, grandmother will have used $3,000 of her lifetime gift and estate tax exemption (reduced to $12,917,000), with the balance being covered by the annual exclusion. *She will also be required to report the gift on a gift tax return*.

Annual Exclusion Examples

- **Let's instead assume that the grandmother and grandfather each give $10,000 to the granddaughter.**
- Neither the grandmother's nor grandfather's lifetime exemption will be used, as the gifts will be covered by the annual exclusion and neither will be required to file a gift tax return.
- In the example above, where only the grandmother makes the $20,000 gift, *if she files a gift tax return for 2023 and she and the grandfather consent to "split" the gift*, then the result will be the same as though each gave half the gift, allowing the grandmother to preserve her lifetime exemption.

Unlimited Marital Deduction Gifts

- Transfers between spouses or to certain trusts for spouses, made during life or at death, can also be gift and estate tax-free due to the unlimited marital deduction.
- Though such gifts may be included in the estate of the donee spouse.

Sunset of the Lifetime Exemption

- The current lifetime gift and estate tax exemption amount is a result of the 2017 Tax Cuts and Jobs Act (TCJA), which doubled the lifetime estate and gift tax exemption amount from $5.6 million to $11.18 million for individuals, indexed for inflation after 2018.
- Due to a sunset of the TCJA, this increased, or "bonus" exemption, will disappear beginning January 1, 2026, with the gift and estate tax exemption at that time being reduced to $5 million, adjusted for inflation, unless the higher exemption is extended by Congress.
- Currently, it is believed that the lifetime exemption beginning in 2026 will be around an estimated $7 million per individual.
- Consider that the loss of additional lifetime exemption from $12.92 million to $7 million would result in an increase in estate taxes of $2,368,000, assuming a 40 percent rate.

Sunset of the Lifetime Exemption

- As a result of the sunset, there is an incentive to use the bonus exemption now while it is still available. Otherwise, you lose it. This can be illustrated by the following examples.

Spousal Lifetime Access Trusts

- A commonly used estate planning technique to use lifetime exemption is the creation of a "spousal lifetime access trust," or SLAT.
- With a SLAT, the donor spouse creates and funds a trust for the other spouse, with the donee spouse having the right to receive distributions during life.
- Sometimes a SLAT is created to take advantage of the unlimited marital deduction. However, a SLAT can instead be designed to use all or a portion of the donor spouse's lifetime exemption while it is available, allowing the assets to continue to grow outside of the donor's (and the donee's) taxable estate.
- As long as the spouses remain married, the donor spouse may still be able to indirectly benefit from the donee spouse's ability to use the SLAT assets.

SLAT Examples

- **In regard to the sunset, suppose that a donor spouse creates and funds a SLAT in 2023 in the amount of $9 million, leaving $3,920,000 in available lifetime exemption.**
- In 2026, when the lifetime exemption is reduced to $7 million, the donor spouse will have <u>no</u> lifetime exemption remaining. In fact, the donor spouse will continue to have no lifetime exemption until inflation adjustments cause the lifetime exemption amount to exceed $9 million, assuming that the lifetime exemption will continue to adjust for inflation.
- However, the donor spouse will have benefitted from using an additional $2 million in bonus exemption.

SLAT Examples

- What if both spouses intend to create a SLAT for the other? Things can get a bit more interesting.
- **Say H creates a SLAT for W with $6 million in assets, and W funds a SLAT for H with $6 million in assets.**
- In 2026, when the lifetime exemption has been reduced to $7 million, H and W will each have $1 million in lifetime exemption remaining (<u>$2 million total</u>) and will have sheltered $12 million in assets from estate taxes.

SLAT Examples

- **Consider instead that H funded a SLAT for W in 2023 with $12 million in assets. W does not fund a SLAT for H.**
- In 2026, H will have no exemption available. However, W will still have her full $7 million lifetime exemption available and $12 million sheltered from estate taxes, meaning that an <u>additional $5 million</u> over the prior example would be available to shelter assets in the future from estate or gift taxes.

Gift Splitting Considerations

- The same concept should be considered for spouses using gift splitting.
- **For example, consider the same situation as above, except that in 2023, H funds a trust for grandchildren using $12 million of assets and W consents to split the gift on a gift tax return with H.**
- As a result, each will have used $6 million of lifetime exemption and will each be left with $1 million (<u>$2 million total</u>) of lifetime exemption in 2026.
- If, however, H and W didn’t split the gift, then W would still be left with the full <u>$7 million</u> available in 2026.

Clawback an Issue?

- What if someone dies after 2025 with the lifetime exemption being reduced but having used the bonus exemption?
- Fortunately, the IRS has indicated in guidance that even if the lifetime gift and estate tax exemption decreases, any previously used exemption will still be respected at death.
- In other words, with a few exceptions, there will be no "clawback" of previously used gift tax exemption at the donor's death, even if the donor made gifts during life in excess of the available estate tax exemption amount at death.

State Level Transfer Tax Planning Needed

- In addition to the federal estate taxes, a number of states impose their own estate and inheritance taxes.
- Currently, 17 states and the District of Columbia impose an estate or inheritance tax, with exemptions among the states varying greatly.
- As a result, additional planning to coordinate state taxes and exemptions with the federal taxes and exemptions should be considered.

Don’t Forget about the Generation-Skipping Transfer (GST) Tax and Exemption

- Currently, the GST tax exemption is the same as the gift and estate tax lifetime exemption - $12,920,000 per individual. However, it is not unified.
- The GST tax exemption sunsets like the gift and estate tax lifetime exemption.
- Consider allocation of GST exemption to non-exempt trusts (late allocation) or pulling non-exempt trusts into estates of those not subject to estate taxes by formula.

Questions?

GETTING IN TOUCH

Keith Grissom

314-345-4744

kgrissom@Greensfelder.com