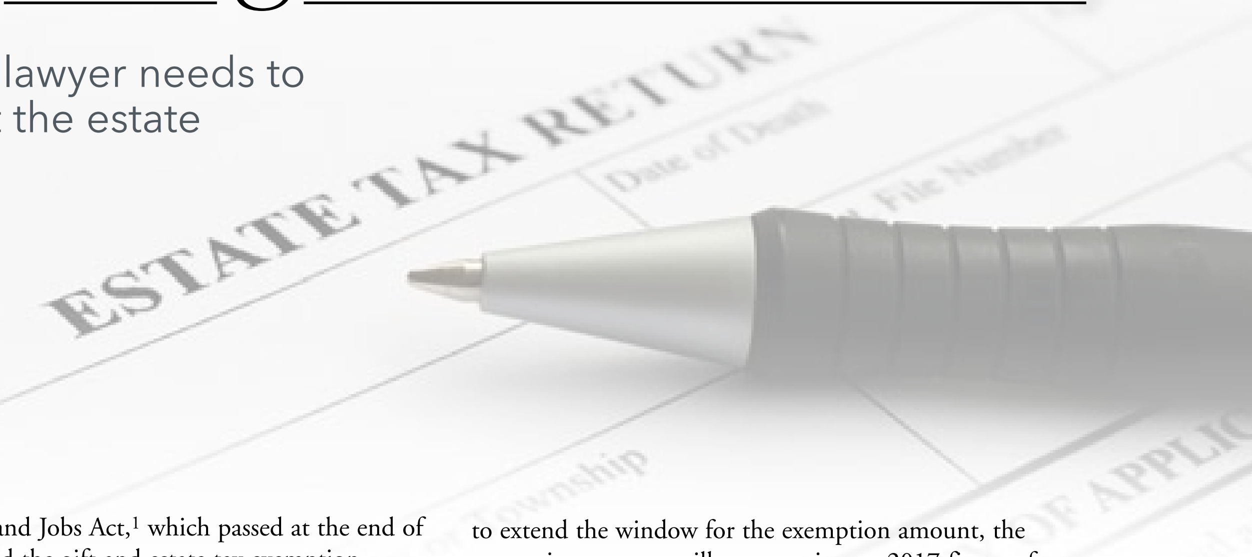
Preparing for the Sunset

What every lawyer needs to know about the estate and gift tax.



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The Tax Cuts and Jobs Act,[1] which passed at the end of 2017, doubled the gift and estate tax exemption. Currently, only the wealthiest Americans need to worry about the estate tax since the exemption is over $13 million per person. However, this could be changing. Unless Congress acts, the current law is scheduled to sunset at the end of 2025. Here's what you need to know when you are advising clients on their gift and estate tax planning strategies.

HOW THE GIFT AND ESTATE TAX WORKS

Each person has an exemption amount. The exemption is the amount of non-charitable gifts a person can make before the gift and estate tax goes into effect. These gifts can be given during the person's lifetime, after their death, or a combination of the two. Any non-charitable gift that exceeds the exemption amount is subject to a 40% tax, payable by the giver (not the recipient). Texas does not have a state estate or inheritance tax.

WHO PAYS GIFT AND ESTATE TAX NOW

Over the past two decades, there have been significant changes in the estate and gift tax rates. The exemption amount has increased, while the tax rate has decreased. In 2003, the estate tax exemption was $1 million per person with a maximum tax rate of 49%. However, in 2009, the exemption increased to $3.5 million, with a 45% tax on amounts above that.

The current exemption is $13.61 million per person, with a 40% tax above that amount. This means that in 2024, a married couple with less than $27.22 million can leave all of their assets to their children or other beneficiaries without paying any estate tax. As a result, very few people have to pay estate and gift tax today. In fact, less than 0.1% of people who passed away in 2020 had to pay any estate tax.[2]

WHAT ABOUT THE SUNSET

When the Tax Cuts and Jobs Act passed in 2017, the exemption amount doubled. However, this provision will expire, or sunset, at the end of 2025. If Congress doesn't act to extend the window for the exemption amount, the exemption amount will revert to its pre-2017 figure of roughly $6 million or $7 million per person on January 1, 2026.[3]

WHAT MY CLIENT SHOULD DO BEFORE THE SUNSET

There is a lot of discussion about how to "lock in" the increased gift and estate tax exemption before sunset. To do this completely, an individual would have to give away his or her entire remaining exemption amount now. Is that what he or she should be doing? The answer depends on the level of wealth as outlined below:

$7 Million or Less

Families with less than $7 million can sleep easy as they are unlikely to be impacted by the estate tax sunset. Exceptions may exist for assets that are expected to appreciate rapidly or for individuals with significant life insurance policies since life insurance proceeds are usually included in the estate for estate tax purposes.

$7 Million to $50 Million

The sunset puts families in the $7 million to $50 million range in the most difficult position. Giving away $13.61 million is the only certain way to lock in the high exemption amounts, but this level of giving may not be prudent since it could materially affect ongoing income or lifestyle. In estate planning, we never want the tax savings to outweigh the practical considerations.

$50 Million Plus

For families with assets valued at $50 million or more, taking advantage of the increased exemption before sunset usually makes sense.

However, gifts do not need to be made directly to beneficiaries, nor do the gifts need to be made in cash—assets can be gifted in kind and to trusts for the beneficiaries. Dynasty trusts can continue for multiple generations and may be particularly attractive with the current increased exemption.

Additionally, the IRS has confirmed that, with a few exceptions, pre-2026 gifts will be grandfathered and will not be subject to additional estate tax.

NEXT STEPS

Before sunset, review and ensure that estate plans still accomplish all intended objectives. If a taxable estate post-sunset is likely, you may want to consider some lifetime gifting opportunities. These include:

Making Annual Exclusion Gifts

Each individual has the option to make small annual exclusion gifts to their family members and others without having to pay taxes. In 2024, an individual can give up to $18,000 to another person, and the gift will not be taxable for tax purposes. It does not have to be reported to the IRS.

These gifts can really add up. For example, if a married couple each makes annual exclusion gifts to five grandchildren ($18,000 times two spouses, times five grandchildren), they can transfer $180,000 per year without using any of their exemption.

Gifts to trusts generally do not qualify for the annual exclusion. However, an outright gift to another person, a contribution to a 529 plan for education, or a Uniform Transfers to Minors Act, or UTMA, usually qualifies for the annual exclusion.

Prefunding Education (529 Accounts)

A Section 529 account is a great option for tax-deferred savings for education. When a person contributes money to a 529 plan, it is treated as a gift to the beneficiary of the plan.

You can put up to five years' worth of gifts into a 529 plan at once, which maximizes tax-free growth within the plan. However, it's important to note that such a gift counts toward the annual exclusion gifts to the beneficiary for the next five years.

Paying Tuition

You can pay tuition on another person's behalf directly to a school or other educational provider free of gift tax. This exclusion only applies to tuition fees and not to other educational expenses such as room, board, or books.

Paying Medical Expenses

You can pay medical expenses directly to the hospital or provider on behalf of another person free of gift tax. For purposes of this exclusion, premiums for healthcare insurance are generally considered a medical expense.

Leveraging Lifetime Gifts

A person who wishes to reduce their estate for estate tax purposes might consider making gifts that use their exemption. As mentioned above, in 2024, an individual's exemption amount is $13.61 million. By making gifts that use their exemption during their lifetime, they can potentially eliminate any future appreciation from their estate. In addition, by making these gifts before the potential sunset at the end of 2025, they can potentially take advantage of the higher exemption.

For instance, suppose an individual has made $12 million of taxable gifts by the end of 2025, and because of the scheduled sunset, the lifetime exemption is reduced to $7 million in 2026. In that case, the person generally won't be subject to gift or estate taxes on the $5 million of taxable gifts that they made while the higher exemption was in place.

When making gifts that use his or her lifetime exemption, an individual might make gifts to an irrevocable trust for his or her spouse and descendants (sometimes called a Spousal Lifetime Access Trust, or SLAT) or an irrevocable trust for the benefit of his or her descendants. Using a trust may offer important advantages over outright gifts. A trust can potentially insulate the trust property from claims of a beneficiary's creditors (including those of a spouse or former spouse), and it can potentially keep the trust property out of a beneficiary's estate for estate tax purposes. A trust, however, requires proper administration, which involves some time and expense. Additionally, gifts to an irrevocable trust generally are not subject to a step-up in basis for income tax purposes after the giver's death.

Charitable Giving

Gifts to charity are always exempt from gift or estate tax, so supporting the causes and concerns you care about is always a great plan! Utilizing a donor-advised fund for charitable giving offers many advantages, including the opportunity to give anonymously, gift appreciated stock (thus avoiding capital gains tax), and make charitable gifts today while postponing the decision on how the funds will be used.

The sun may be setting on the current exemption amount, but thoughtful planning can help reduce the chill of the evening air. **TBJ**

Notes

1. Tax Cuts and Jobs Act of 2017, HR 1, 115th Cong. (2017).
2. The Tax Policy Center's Briefing Book, https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax.
3. Roger Wohlner, "These Tax Cuts Are Sunsetting in 2026. Are Your Clients Ready?" ALM: Think Advisor (November 22, 2023), https://www.thinkadvisor.com/2023/11/22/these-tax-cuts-are-sunsetting-in-2026-are-your-clients-ready/.

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