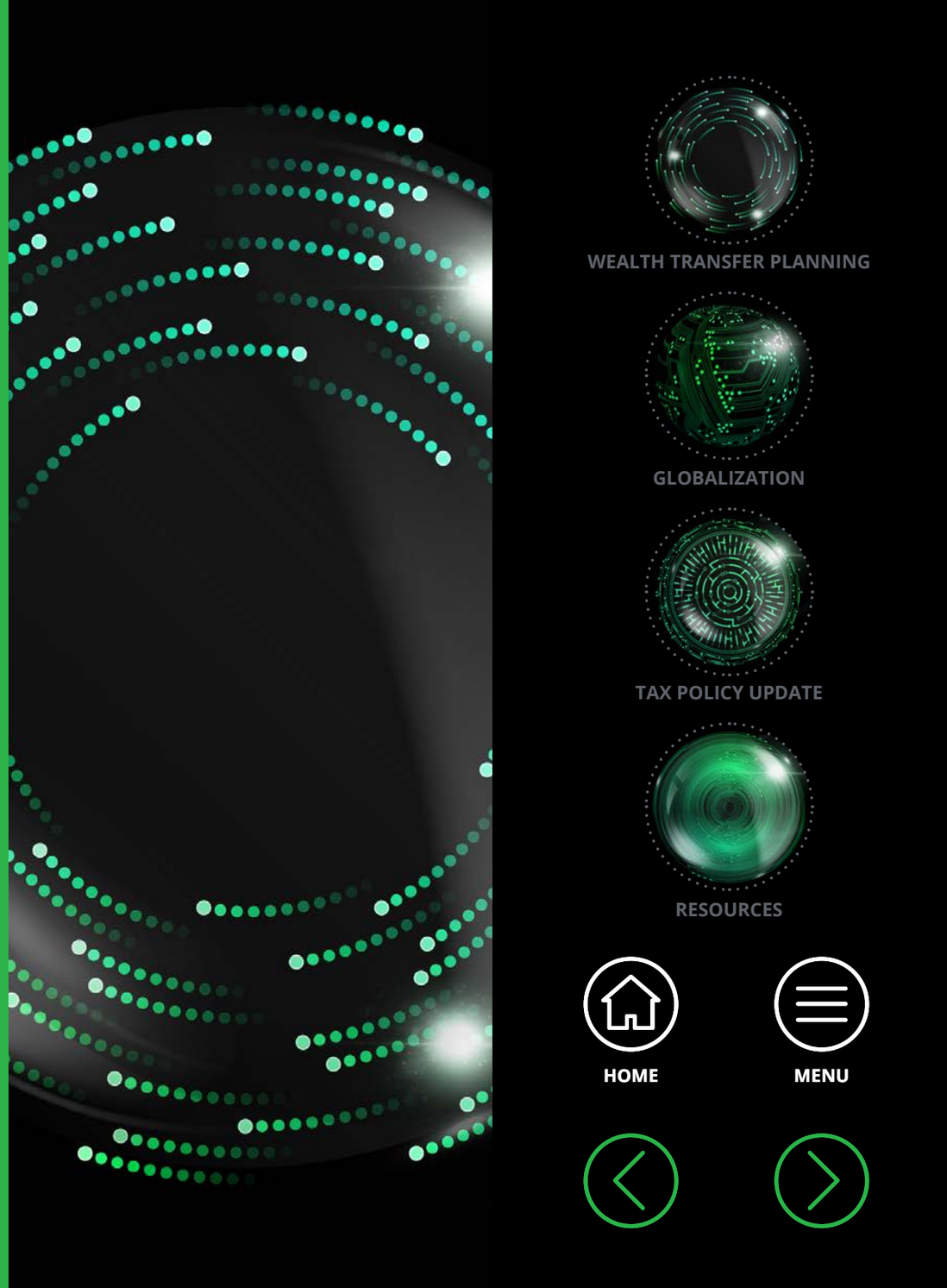
Wealth transfer planning

Familiar landscape. New opportunities. Where do you start?

In contrast to the individual income tax landscape, the wealth transfer tax-planning landscape may seem very familiar. Yet the doubling of the exclusion amount provides new opportunities for individuals to move their wealth transfer plan further down the path before these favorable provisions sunset.



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The transfer tax system, which includes gift, estate, and generation-skipping transfer taxes, has been the object of extensive political debate for the last twenty years. Yearly bills in both the Senate and the House of Representatives have proposed repeal of the system outright. While the political landscape necessary to accomplish outright repeal never materialized, Congress has twice in the last ten years delivered significant transfer tax relief by increasing the applicable exclusion amount—the amount each taxpayer "excludes" from transfer taxation—from $3.5 million in 2009 to $5 million in 2010, and from $5.49 million in 2017 to $11.18 million in 2018. Since 2010, the applicable exclusion amount has been indexed for inflation, with the 2019 exclusion amount equaling $11.4 million per individual.

To give you an idea of how transformative this relief has been, consider that in 2000, when the exclusion amount was a mere $675,000, 108,300 estate tax returns were filed.[1] In 2011, when the exclusion amount was $5 million, approximately 4,600 returns were filed. In 2018, although the figures are not yet available, it is projected that total returns will number only 4,000. These figures become more impressive when considering that in 2000, some 2.8 million Americans passed away, compared to about 3.2 million in 2018. At first blush, these numbers may seem to suggest that only one in every 800 Americans needs to worry about the transfer tax. That, however, is an oversimplification. First, while the applicable exclusion amount is indexed for inflation, wealth generation is exponentially greater than the inflation rate. For example, while estate tax returns filed in 2011 numbered 4,600, the returns filed in 2017 were 12,700, an increase during the "indexed exclusion amount period" of 8,100 returns. Further, it fails to consider those who, at death, did not have an estate greater than the applicable exclusion amount, but would have if they had not engaged in wealth transfer during life. While that number is impossible to know, it is interesting to note that in 2017, more than 239,000 gift tax returns were filed reporting over $74.73 billion in gifts. Comparatively, the gross estates reported on the 12,700 estate tax returns filed in 2017 totaled $192.1 billion.

Of concern, however, is that the estate tax exemption increase under the 2017 Tax Act is legislated to end. Assuming Congress allows the provisions of the 2017 Tax Act to lapse at the end of 2025, estate and gift taxes will revert to pre-2017 rules. Specifically, transfer taxes will be calculated using an exclusion amount of $5 million indexed for inflation from 2010 and a continuing top effective tax rate of 40 percent. Thus, there may be a window of opportunity.

[1] https://www.irs.gov/statistics/soi-tax-stats-estate-tax-statistics. References to total returns filed have been rounded to the nearest thousandth.

Familiar landscape. New opportunities. Where do you start?

One point in this environment to emphasize, is that failure to utilize the full $11.4 million applicable exclusion amount, including the inflation adjustments that will occur between now and 2026, may result in the unused amounts being subject to wealth transfer taxes that would not have otherwise occurred.

Utilizing the applicable exclusion amount

Failing to avail oneself of the increased exclusion amount may result in an economic impact to the family. Consider the following illustration.
In Scenario 2, the taxpayer's heirs will have $2,160,000 more than they would have otherwise enjoyed—an increase in their inherited wealth of 15%.

Scenario 1

Facts:

- Single taxpayer with an estate of $15M on 12/31/25
- One prior gift in 2015 of $5M
- 1/1/2026 date of death, assuming at such time the applicable exclusion amount (AEA) has reverted to $5.6M and the top marginal estate tax rate is 40%

Outcome:

- The taxpayer has a taxable estate of $20M ($15M gross estate at death plus $5M of adjusted taxable gifts).
- The computed tax is $7,945,800 reduced by the 2026 unified credit amount ($2,185,800).
- As no taxable gifts were made in excess of the 2026 AEA, there is no section 2001(b)(2) credit.
- Total net tax liability of $5,760,000.

Estate Assets	15,000,000
Adjusted Taxable Gifts	5,000,000
Taxable Estate	20,000,000
Gross Estate Tax (40%)	**7,945,800**
Section 2001(b)(2) credit	–
	7,945,800
Less Unified Credit	(2,185,800)
Net Estate Tax	**5,760,000**

Scenario 2

Facts:

- Same as Scenario 1, except a second gift is made in 2019 of $6M (and therefore, the estate value on 12/31/25 is $9M)
- The AEA in 2019 is $11.4M

Outcome:

- The taxpayer still has a $20M taxable estate ($9M gross estate at death plus $11M of adjusted taxable gifts).
- The computed tax is the same $7,945,800 reduced by:
  - The 2026 unified credit amount ($2,185,800), and
  - The section 2001(b)(2) credit on the adjusted taxable gifts in excess of the 2026 AEA ([$11M - $5.6M] * 40% = $2,160,000).
- Total net tax liability of $3,600,000

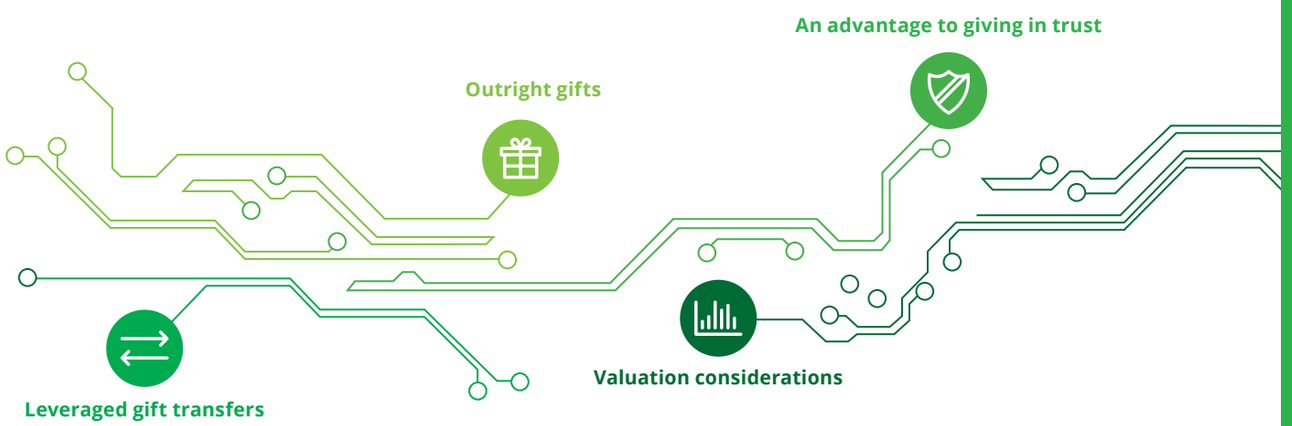
Estate Assets	9,000,000
Adjusted Taxable Gifts	11,000,000
Taxable Estate	20,000,000
Gross Estate Tax (40%)	**7,945,800**
Section 2001(b)(2) credit	(2,160,000)
	5,785,800
Less Unified Credit	(2,185,800)
Net Estate Tax	**3,600,000**
Benefit	**2,160,000**

Familiar landscape. New opportunities. Where do you start?

What we consider next is what the current environment particularly encourages, which is simple ideas on a bigger scale—at least for those who have sufficient wealth to believe that the transfer taxes will always apply to them.

But, before we begin, let's discuss a technical point. Specifically, if you use the enhanced exclusion now when making gifts, what protects you from later estate tax when the exclusion amount reverts to a smaller number? This question was addressed in guidance released by the IRS in November 2018. Specifically, the exclusion amount that governs the estate tax computations will be the greater of the exclusion amount at the date of death or the exclusion amount used during life. This is not as cryptic as it may sound. Recall that after the 2017 Tax Act sunsets, the reset smaller exclusion amount is still indexed for inflation. At some point, even this smaller number will have grown to exceed the maximum exclusion amount available in 2025. Stated differently, the use of the enhanced exclusion amount will continue to be honored notwithstanding future law changes.

Click the icons below to explore:

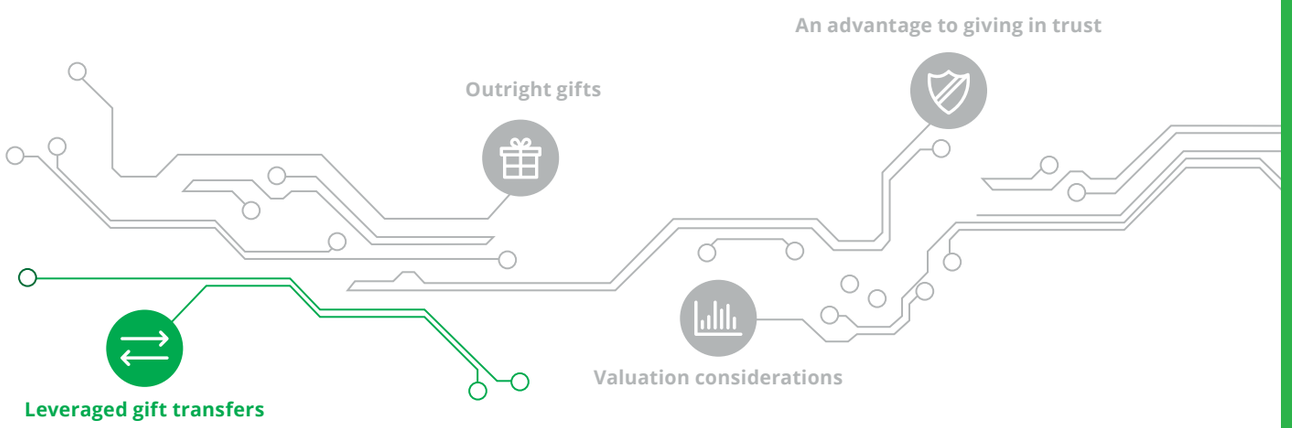


Familiar concepts, larger scale

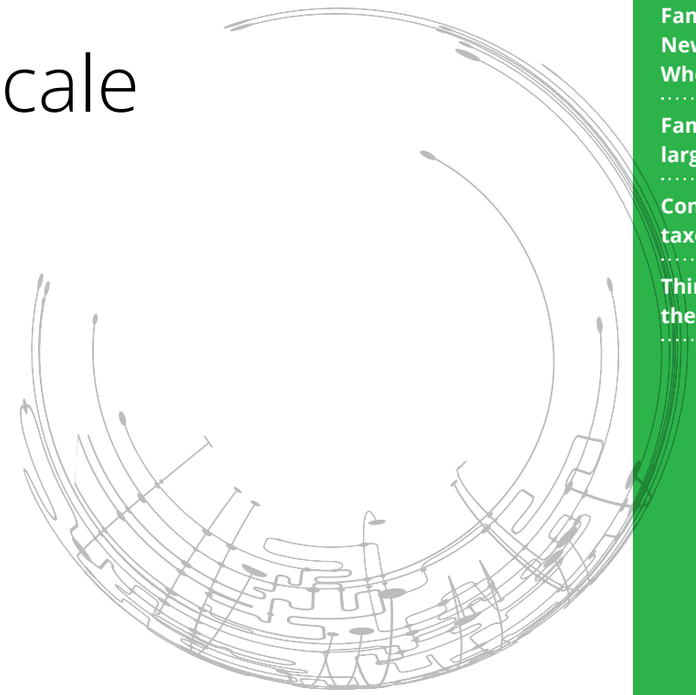
Leveraged gift transfers

Prior to the 2017 Tax Act, many taxpayers used the smaller $5.49 million exclusion amount as the foundation for leveraged transactions; for example, a gift to a special purpose trust, followed by a purchase of assets from the grantor at some reasonable multiple of the gift amount. Thereafter, because the exclusion amount had been utilized, such a taxpayer would then use grantor retained annuity trusts (GRATs) to transfer the appreciation on property away from his or her estate. GRATs, appropriately executed, are often effective for this purpose because they result in small taxable transfers.

If you wish to move assets more than the $11.4 million exclusion amount ($22.8 million per couple) through transactions during your lifetime, using the increased exclusion amount as seed capital to engage in similarly leveraged transactions, followed by the continued use of GRATs, may be an effective option. You and your advisers should compare the difference in projected wealth transfer over time between an outright gift using the $11.4 million exclusion and a transaction that leverages the $11.4 million amount. Of course, it is important to recognize the inherent economic risks of extreme leverage. Further, keep in mind that the debt obligation must be serviced pursuant to its terms to avoid later gift and estate tax complications.



Familiar concepts, larger scale



Outright gifts

At $11.4 million, or, as noted, $22.8 million for a married couple, the enhanced exclusion amount is large enough that simple outright gifts, whether direct or in trust, can be an efficient mechanism for transferring the desired amount of wealth without the need for greater sophistication. Determining the appropriate assets to transfer, however, is not always clear. From the perspective of tax efficiency, the leading gift candidates are those assets that are most likely to experience the greatest amount of post-transfer yield (in this sense, yield includes income production and appreciation). Successful transfers may not only bestow the greatest value upon your donee(s); they also may remove the assets with the most growth potential from your estate, thus potentially reducing your future transfer tax exposure.

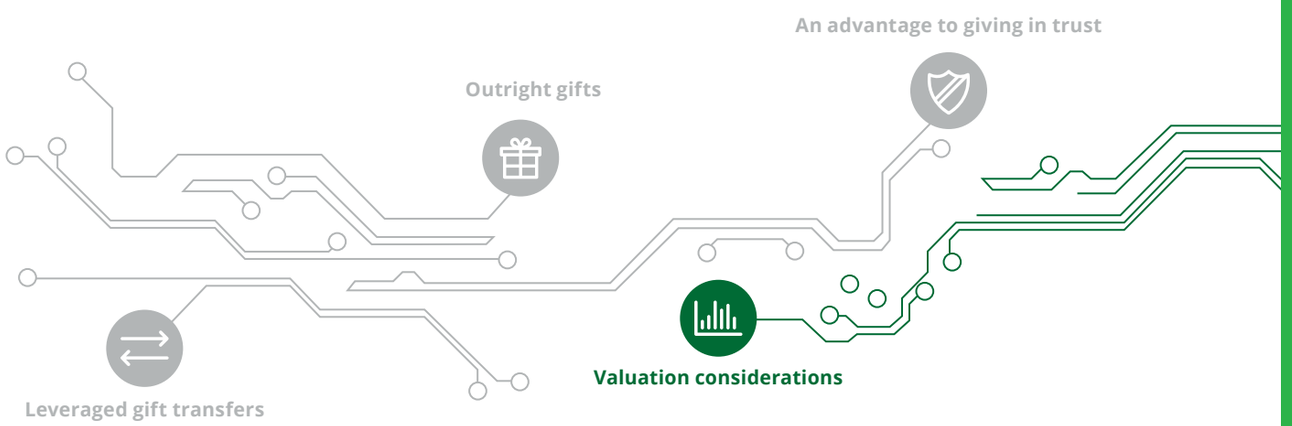
Familiar concepts, larger scale

Valuation considerations

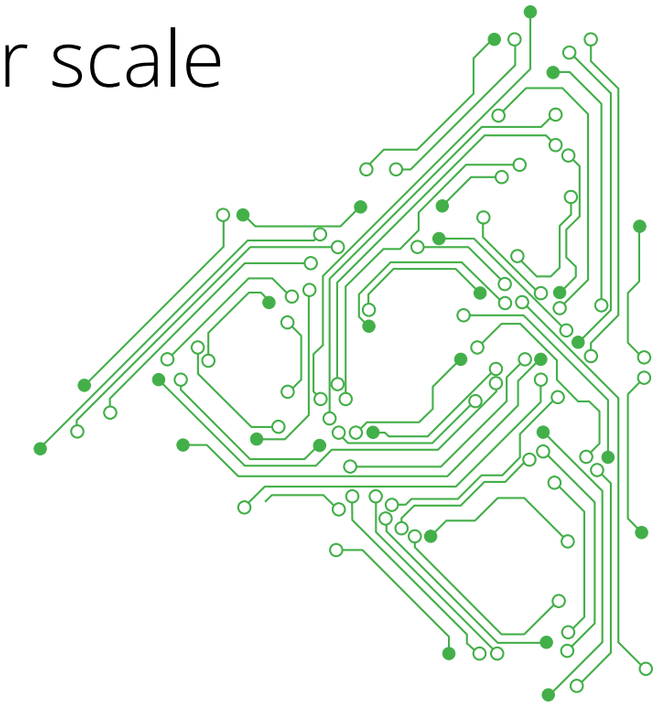
Minority interests in closely held businesses, fractional interests in real estate, interests in entities owning significant real estate holdings, interests in private equity funds or other investment entities, and perhaps even interests in family-owned investment entities, may serve as successful candidates for gift giving since such interests are often value stressed. Specifically, many of the interests mentioned above are valued at less than a proportionate fair market value of the enterprise or the asset itself, and therefore are susceptible to IRS scrutiny.

Ultimately, however, whether a gift transfer is successful or not is determined by whether the enterprise is successful (for example, by appreciating and or generating income, which it distributes to its owners) after the transfer date. Even if you prevail with respect to a modest valuation determination, such discounts only reduce the threshold for success or, in the alternative, reduce the tax cost of the transfer if the enterprise is not ultimately successful.

One caveat: When giving assets other than cash, the donee's basis in the assets received is the donor's basis. Thus, if the basis is very low relative to fair market value, the immediate disposition of the asset after the gift will result in after-tax proceeds much less than the reported gift. Some consideration must be given to what the donee is likely to do with the property received; and, if it is likely to be disposed of, when that disposition might occur.

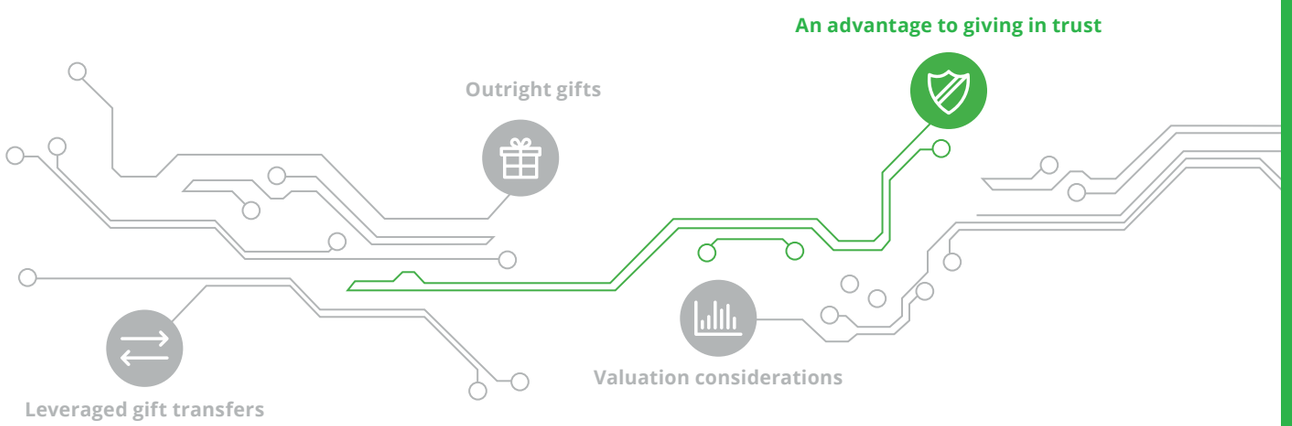


Familiar concepts, larger scale



An advantage to giving in trust

Do not overlook the wealth transfer advantages of transfers made in favor of trusts determined, for income tax purposes, to be grantor trusts. Such trusts require the donor to report the income tax attributes of the trust, and pay any related income taxes, as if the donor were the legal owner of the trust's assets. This allows the grantor trust to grow unencumbered by income taxes and, because the related tax payments are the primary obligation of the grantor, paying the taxes is not considered a separate indirect gift and is not the subject of a further gift tax.



Consider paying gift taxes currently

Except for one year, 2010, the current 40 percent transfer tax rate is the lowest it has been since former president Franklin D. Roosevelt's first term. Given the variation in the top transfer tax rates over the last century, whether the current 40 percent rate will remain in place is speculative. Family wealth is ultimately enhanced when taxed at the lowest possible rate. Although perhaps counterintuitive, this conclusion remains true even considering the time value of money. Furthermore, the gift tax is "tax exclusive," meaning that the funds used to pay the tax are not subject to gift tax. The same is not true of the estate tax—which is "tax inclusive." The estate tax is levied against the value of the gross estate, including the funds that will be used to pay the tax. The sidebar illustrates both principles noted above.

Making gifts large enough to pay gift tax—The Bold Play

Estate tax transfers are currently subject to a 40% effective transfer tax rate, but life time transfers experience an effective tax rate of 28.57%. The difference is that the wealth used to pay the gift tax isn't also subject to tax. Let's illustrate this concept with a hypothetical $100 bundle of assets to transfer (from which taxes will also be paid). As shown below, paying gift tax can actually increase the family's retained wealth by 19.05%.

Lifetime Transfer

This is the result a taxpayer making a gift can expect if she lives for an additional three years following the gift.

Transfer at death

This is the result, under current law, if those same assets are held until death.

The time value of money does not change the conclusion that it is better to pay gift tax now. Let's assume the same hypothetical $100 bundle of assets to transfer (from which taxes will be paid), and that:

- The 40% rate remains constant, and
- We know with certainty that the assets transferred today will double in value prior to the donor's death.

Lifetime Transfer

This is the result a taxpayer making a gift can expect. On the date of the donor's death, the beneficiaries' assets would be worth $142.86 (2 x $71.43).

Transfer at death

This is the result if those same assets were held until death, which indicates that the inherited assets are worth $120.

Paying gift tax currently still increases the family's retained wealth, even if rates remain unchanged, by 19.05%.

Transfer Tax | Amount to beneficiaries at time of transfer | Appreciation to beneficiaries post-transfer

Thinking outside the box

Net gifts and bargain sales

A net gift is a gift conditioned on the donee paying the related gift tax. It is called a net gift because the amount subject to tax is the net of the value of the property transferred less the amount that the donee will reimburse the donor.

A net gift can be useful when you want to make a significant transfer but lack the liquidity to pay the resulting tax or are unwilling to bear the tax burden; or, in situations where the asset being transferred is illiquid and the donee is better positioned to shoulder the burden of paying the related gift tax. The net gift, however, also introduces a second caveat to its ultimate effectiveness in preserving family wealth: The net gift does not give rise to an offsetting income tax liability (that is, a net gift is treated as a bargain sale, thus a gift of property that has little or no basis may give rise to a significant income tax obligation depending on the nature of the asset transferred).

Renouncing interests in trusts

In the current economic environment, under certain circumstances, it may be favorable to renounce all or part of an interest in an existing marital trust, including a qualified terminable interest property (QTIP) trust. A renunciation of an interest in a QTIP trust is considered to be a gift by the beneficiary spouse, who is obligated to pay the gift tax, on the value of the trust's assets; however, the donees (the remainderman of the trust) must reimburse the renouncing beneficiary spouse for the gift tax properly apportioned to the value of the remainder interest. Valuation considerations in conjunction with the low prevailing interest rates have made the economics of renouncing an interest in a QTIP trust relatively more appealing because the amount of gift tax properly apportioned to the income interest—the portion of the gift tax that the renouncing spouse is not required to reimburse—is disproportionately low. Note that one need not renounce the whole trust. If supported by state law or the provisions of the trust, one can sever a QTIP trust into two or more identical trusts that are funded disproportionately. After such a severance, the renunciation would be made only of the trust holding the assets in which there was no longer any interest.

The next installment of the *Guide* will discuss more subtle uses of the enhanced exclusion—including "tuning up" prior planning transactions and transfers structured to avoid "donor's remorse" and transfer that concentrate on the generation-skipping transfer tax.