

GIFT AND ESTATE TAX LAWS ARE CHANGING, PERHAPS EARLIER THAN EXPECTED

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Background. In order to understand the dramatic changes which may occur as early as 2021, we need some background. The federal, gift, estate and GST taxes apply to transfers of property which you make during your lifetime or at your death. There are two exceptions to these taxes. The first, the annual exclusion, presently allows you to make \$15,000 gifts to as many persons as you want each year. The second exclusion is much more significant. This is called the basic exclusion amount. In 2001, this amount allowed you to transfer \$675,000 either during your lifetime or at your death free of these taxes. During the period 2001 through 2009, this exclusion increased to \$3,500,000. The maximum tax rate was forty-five percent. Under the Tax Relief Unemployment Insurance Reauthorization and Job Creation Act, enacted in December 2010, the applicable exclusion amount was increased to \$5,000,000, adjusted for inflation, and the maximum rate was lowered to forty percent.

Good News! The Tax Cuts and Jobs Act of 2017 doubled the \$5,000,000 amount to \$10,000,000, adjusted for inflation. Today this adjusted amount is \$11,400,000. The annual exclusion amount has been adjusted to \$15,000 per person. Therefore, for many persons, these taxes have, in effect, been repealed. However, please read on. This good news is temporary.

Bad News! The first bad news is that these provisions “sunset” as of January 1, 2026. That is, in six years, the applicable exclusion amount goes back to what the law was before the 2017 Act was enacted: \$5,000,000, adjusted for inflation.

Good News! There will not be any “claw back” of the higher amount when the exclusion is reduced. This is best explained through an example. If you give \$10,000,000 to trusts for your children and grandchildren, and then in 2026 the law goes back to a \$5,000,000 basic exclusion amount, you will not lose the benefit of your prior \$10,000,000 gift. That is, the IRS will not be able to “claw back” the excess amount and tax it.

More News—the Political Winds. These tax laws may change dramatically in 2021. This news depends upon political events. If the Democrats are able to elect majorities in both houses of Congress and win the presidential race, then substantial changes could occur. The leading candidates for the Democratic presidential nomination have all stated that they will make major changes to these tax laws.

A representative example of the candidates’ proposals is contained in Senate Bill 309, which has already been introduced by Senator Sanders. This bill contains the following proposed changes, which include some that the United States Treasury

developed during the prior Democratic administration.

- The applicable exclusion amount would be reduced to \$3,500,000;
- The estate tax rate, which would apply to all assets in excess of \$3,500,000, would increase from the present forty percent rate to forty-five percent;
- Further, for large estates, this rate continues to increase all the way up to seventy-seven percent;
- During a person's lifetime, they could only use \$1,000,000 of the \$3,500,000 for lifetime gifts;
- Annual exclusion gifts would be limited to \$10,000, and each person could only make a total of \$20,000 of such gifts during a year;
- Minority interest discounts, which have long been supported by case law, would be eliminated for most assets;
- GST exempt perpetual trusts would be limited to fifty years. This would greatly reduce the tax advantages of perpetual trusts;
- Assets in grantor trusts, even though the trusts were irrevocable, would be included in the grantor's gross estate at death, and distributions would be treated as gifts by the grantor during the grantor's lifetime. If the assets of the grantor trust are included in the grantor's estate, there would be no estate or gift tax advantage to forming grantor trusts, selling assets to grantor trusts, or swapping assets with a grantor trust;

- Grantor Retained Annuity Trusts would be required to have a minimum duration of ten years and produce a gift of at least twenty-five percent of the assets transferred to the trust. This would eliminate what has presently been a gift-tax free method for transferring growth out of the grantor's estate; and
- The step-up in basis of assets at death would be eliminated. This would end the one good thing that happens when you die; the long-established statutory rule that when someone dies the basis of assets included in their gross estate are adjusted to fair market value. This has allowed heirs to sell assets without paying income tax on the appreciation of the assets.

Bad News! The above-described changes, not only reduce the exclusion amount to \$3,500,000 and increase the tax rate forty-five percent, but also eliminate many of the major tax planning techniques used to minimize estate taxes.

Good News! The above 2021 changes, if they occur as stated in Senate Bill 309, will only apply to future contributions to existing trusts and to trusts created after the effective date of the law. Trusts which already exist, and which have assets transferred to them, will be "grandfathered."

Use It or Lose It. In summary, the combination of the 2026 "sunset" and the 2021 possible political change have produced a "use it or lose it" situation. If you gift or sell assets to irrevocable trusts prior to those events, then the new tax rules will very probably not apply to those assets. That is, with proper planning, those assets will be excluded from the new tax laws.

What Should You Do? If you have assets which at your death, or if you are married at the death of the surviving spouse, would be more than \$3,500,000 (reduced by taxable gifts you already made), then you should consider accomplishing further estate planning prior to 2021. Until then, you can:

- Make tax free gifts of assets up to the present \$11,400,000 basic exclusion amount;
- Take advantage of minority interest and lack of marketability discounts;
- Make annual exclusion gifts of \$15,000 per year to as many beneficiaries as you want;
- Create perpetual trusts which will be estate and GST tax free as long as they hold the assets even as they appreciate;
- Sell assets to, or swap assets with, “grantor trusts” which you create during your lifetime without any income, gift or estate tax consequences; and
- Create Grantor Retained Annuity Trusts gift tax free to transfer future appreciation of assets to irrevocable trusts which will not be subject to estate tax.

Little Downside. It has always been advantageous to use your applicable exclusion amount and annual exclusion gifts to fund irrevocable trusts for you and your beneficiaries **earlier rather than later**. This is because then all of the growth of the assets is inside the trusts and is not subject to future estate or GST tax.

To implement your gifting and other transfers of assets, you can create a trust for your family and also be a discretionary beneficiary of that trust. This is because Alaska is the leader of now nineteen states which have enacted laws allowing the grantor to also be a beneficiary. Your creditors will not be able to reach the assets in the trust, and the assets will be excluded from the federal estate tax at your death.

When Should You Do the Planning?

A quite normal reaction to the above situation is:

Well, 2026 is six years away, and I can just wait and see how the elections go in November of 2020. It will take Congress some months to pass legislation in 2021. Therefore, I have plenty of time.

There are two significant problems to this approach:

- First, the effective date of new legislation could well be the first of the year in 2021. This is not unusual for tax legislation.
- Second, depending on your particular situation, it takes time to organize assets to accomplish proper and effective gifting, sales, GRATs, and similar estate planning approaches. Hurried, last-minute planning is inevitably more expensive, more difficult to be thorough, more susceptible to IRS scrutiny, or may not even be available due to other client projects ahead of yours.

Our office is available to discuss your situation and the planning which would take advantage of the present very attractive gift, estate, and GST laws.

As stated above, many planning opportunities take time to implement. Therefore, it would be better to confer with you sooner rather than later.

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